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IN THE

Supreme Court of the United States

June Term, 1980

No. 79-1426

BANKERS TRUST COMPANY,
Petitioner,

v.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Bankers Trust Company respectfully prays that a writ of certiorari issue to review the order and opinion of the United States District Court of Appeals for the Second Circuit entered in this proceeding on January 25, 1980. That opinion reversed a judgment in favor of petitioner after a jury trial of this securities action and remanded the matter for a new trial.

OPINIONS BELOW

The opinion of the Court of Appeals from which this appeal is taken, reported in [1980 Current Volume] Fed. Sec. L. Rep. (CCH) ¶97,262, appears in the Appendix to this petition at A1. No opinion was rendered by the District Court for the Southern District of New York. Prior opinions in this proceeding reported *sub nom. Mallis* v. *F.D.I.C.*, 407 F. Supp. 7 (S.D.N.Y. 1975), *reversed*, 568 F.2d 824 (2d Cir. 1977), *cert. dismissed as improvidently granted*, 435 U.S. 381 (1978), also appear in the Appendix at A55, A43, and A34, as does an unreported memorandum opinion

of the Supreme Court, County of New York in *Mallis* v. *Kates* (A67).

JURISDICTION

The judgment and opinion of the Court of Appeals were entered on January 25, 1980 (A1, A33). The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. Whether one who neither purchases nor sells securities may nonetheless maintain suit under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder based on his having accepted a pledge of securities as collateral for the repayment of monies advanced to another in a transaction negotiated privately between them?

2. Whether, when all federal claims are dismissed after appeal for failure to state a federal claim, remaining "pendent" state law claims which present difficult and unprecedented issues of state law should be dismissed as well?

STATUTES INVOLVED

Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. §78j, as amended, provides in relevant part:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ...
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or

> contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 under the Securities Exchange Act of 1934, 17 C.F.R. §240.10b-5 provides in relevant part:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,
>
> * * *
>
> (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

STATEMENT OF THE CASE

On February 24, 1972 a lawyer named Jack Arnold entered into an agreement to purchase 40,384 shares of a company called Equity National Industries, Inc. from one Jerome Kates for the sum of $181,000 (729a).[1] On March 1, 1972 Arnold told Samuel Mallis, a dentist, that he needed to come up with $156,000 by March 3 in order to complete the Equity National purchase and that, if he could do so, he would be in a position to make $800,000 within the next 30 days on another transaction he had pending with Kates. Arnold offered Mallis the sum $50,000 if Mallis would advance the $156,000 for the next 30 days (230-232a).

1. References with a small "a" are to the trial record as reproduced in the appendix which was before the Court of Appeals below. References with a large "A" are to the Appendix to this petition.

Mallis was immediately interested in Arnold's proposal and, to raise the money, went with his brother-in-law, Franklyn Kupferman, also a dentist, to John Murfitt, a loan officer employed by Franklin National Bank (220-222a). To obtain the money from Franklin the loan officer Murfitt, with Mallis and Kupferman's knowledge, falsely recorded on Franklin's books that the purpose of the loan was to finance the purchase of real estate (222a). In this manner Mallis and Kupferman in less than two days raised $156,000 to advance to Arnold to finance Arnold's purchase of the Equity National shares so that Arnold, within 30 days, could complete his other deal with Kates, realize his $800,000 profit, and from the proceeds repay Mallis and Kupferman the $156,000 plus a $50,000 profit for the 30 days' use of Franklin National Bank's money.

To complete Arnold's purchase of the Equity National shares from Kates, a closing was held on March 3 attended by Kates, Arnold, a broker named John Fowler, the Franklin officer Murfitt, and a Bankers Trust house attorney Nathan Silverman (323a). The closing was held at Bankers Trust because Kates' Equity National shares were in Bankers Trust's possession at the time, having been pledged to the bank by Kates as collateral for loans the bank had made to Kates some two years previously (28a).

At the closing when Arnold saw the Equity National shares, he inquired about a legend on the certificates indicating that they were not transferable except in accordance with an Escrow Agreement (738a; 83-84a). Kates did not produce a copy of the Escrow Agreement, but gave Arnold an affidavit to the effect that its requirements had been met and that the stock was transferable (323-325a). Murfitt then gave Kates checks for $45,000, which Kates endorsed to Bankers Trust in payment of his debt to the bank, and for the balance of $111,728 which Arnold needed to buy the Equity National shares (160-161a). Bankers Trust on payment of its loan released the shares to Kates who sold them

to Arnold (109-110a). Arnold and Fowler (who was Arnold's partner in the deal) then pledged the Equity National shares to Mallis and Kupferman as collateral for the repayment of their advance of $156,728 plus their anticipated $50,000 profit.[2]

When Kates later failed to go through with his second deal with Arnold and it also developed that the Equity National shares were not transferable, Mallis and Kupferman were left with a loss of $106,000, which they seek to recover from Bankers Trust in this action. Their suit, brought under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder and on common law principles, alleges that Bankers Trust's attorney Silverman had possessed a copy of the Escrow Agreement and was aware of Equity National's claim to the shares but either omitted to disclose this information to Arnold at the closing or affirmatively misrepresented that the shares had value. After a full trial of the issues, a jury rendered a general verdict for Bankers Trust. The Second Circuit Court of Appeals reversed, finding errors in the trial court's charge to the jury. In reversing, the Second Circuit held that, as a matter of law, a pledgee who takes securities as collateral for the repayment of an advance of monies may bring an action under Section 10(b) as a "purchaser" of the shares. It is this issue upon which Bankers Trust seeks the grant of certiorari here.

REASONS FOR GRANTING THE WRIT

Only a purchaser or seller of a security may maintain an action for damages under Section 10(b) of the Securities

2. Arnold and Fowler's pledge to Mallis and Kupferman was made pursuant to a letter agreement between them dated March 3 which was delivered to Mallis after the closing. That agreement provided that "You [Mallis] are to advance the sum of $156,000. ...", that "The shares are to be held as collateral by you", that "[w]ithin 30 days or less you shall be reimbursed the funds advanced by you plus a profit of fifty (50,000.00) thousand dollars. ..." at which time "... you will deliver the shares to Jack J. Arnold. ..." (734a; 127-128a; 247-249a)

Exchange Act of 1934 and Rule 10b-5 thereunder. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). In this case the Second Circuit has twice held that one who accepts a collateral pledge of securities should be treated as a "purchaser" of them for the purpose of entitling him to maintain suit under Section 10(b). After the first of these decisions, hereafter called "Mallis I" (A43), this Court granted certiorari, 431 U.S. 928 (1977), but a factual confusion led to dismissal of the writ (A34). Now, after a full trial, the issue is again presented, this time squarely and unequivocally, by the Second Circuit's present decision (A1), here called "Mallis II", which reiterates the holding of *Mallis I* that as a matter of law acceptance of a pledge of stock is a "purchase" entitling the pledgee to maintain suit for damages under the anti-fraud provisions of the 1934 Act.

Mallis II marks the sixth occasion in the last five years in which one of four circuit Courts of Appeals has passed upon the issue of whether a pledge is a "purchase" or a "sale" under Section 10(b). The Sixth Circuit has followed the Second Circuit's decision in *Mallis I*, but the Fifth and Seventh Circuits have rejected *Mallis I* and have concluded that pledgees and pledgors are not "purchasers" and "sellers" whom Congress intended the anti-fraud provisions of the securities acts to protect. Because of the direct conflict between the circuits on this issue; because the Second Circuit's expansion of Section 10(b) here clashes fatally with the principles which this Court has enunciated in such cases as *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975) and *Teamsters* v. *Daniel*, 439 U.S. 551 (1979), and because of the far-reaching impact of the Second Circuit's decision on the wide range of commercial and individual loan transactions which are typically collateralized by securities, petitioner urges that review by this Court is both appropriate and of public importance.

A. The Second Circuit's Holding In *Mallis II* Clearly Presents The Issue Presented By *Mallis I*: Is A Pledgee of Securities A "Purchaser" Under Section 10(b) As A Matter of Law?

On Bankers Trust's original Rule 12(b) motion for dismissal of this action, Judge Pollack in the Southern District of New York, applying *Blue Chip Stamps*, ruled that plaintiffs Mallis and Kupferman could not state a claim under Section 10(b) and Rule 10b-5 because they were not "purchasers" of a security (A61). Specifically, Judge Pollack held, relying on *McClure* v. *First National Bank of Lubbock*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975), that the acceptance by Mallis and Kupferman of a pledge of the Equity National shares from Arnold was not, as a matter of law, a "purchase" by them of the shares (A61). The Second Circuit in *Mallis I* reversed and, rejecting *McClure*, held that a pledge satisfies the purchase or sale requirement of Section 10(b) as a matter of law. Applying this legal conclusion to the complaint in this case, the *Mallis I* court said "[Mallis and Kupferman] were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge." (A54) This Court granted certiorari "to consider the correctness of these rulings by the Court of Appeals" but dismissed the writ as improvidently granted when, on the oral argument, counsel for Mallis and Kupferman "took the position that 'the mere release of a pledge is not a sale.'" (A35, 41)

On remand for trial in the Southern District of New York, Bankers Trust renewed its motion for dismissal, urging again that plaintiffs were not suing on a fraud committed in connection with their purchase of any security. The District Court, although indicating agreement with Bankers Trust's position,[3] reserved decision on Bankers

3. Just before charging the jury, District Judge Carter advised counsel that he was "almost entirely convinced ..." that "the action which took place in this case is outside the ambit of section 10(b), since I don't see

Trust's motion and sent the case to the jury. Since the jury returned a general verdict for Bankers Trust, the District Court did not have occasion finally to rule on Bankers Trust's motion.

On their appeal following trial Mallis and Kupferman argued that the jury should not have been permitted to consider the question of whether the alleged fraud had occurred in connection with their purchase of a security because, they said, *Mallis I* had already so held. The Court of Appeals in *Mallis II* responded "We do not think our prior decision went so far", describing that prior decision, the holding of *Mallis I*, as a holding that "as a matter of law a pledge might constitute a sale by the pledgor and a purchase by the pledgee; not that the proofs at trial would necessarily demonstrate such a purchase or sale here." (A11-12) Nonetheless, although plaintiffs had testified explicitly at trial that they had not purchased the Equity National shares,[4] the Court of Appeals ruled, based solely on their having accepted the pledge of the Equity National shares from Arnold and Fowler, that Mallis and Kupferman were "purchasers" of these securities:

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this action being in the real sense in connection with the sale of a security .... more or less, as an afterthought, I think the pledge of the securities was made ...." (511a) Judge Carter then said he would send the case to the jury and "If the jury comes in with a verdict [for plaintiffs] you [Bankers Trust] may ask for a judgment NOV and I will have to face my convictions." (511-512a)

4. This is Mallis' testimony on the subject:

> Q You obtained $156,000 together with Dr. Kupferman from Franklin National Bank, is that correct?
>
> A Yes.
>
> Q And you gave Mr. Arnold the use of those funds, is that correct?
>
> A Yes.
>
> Q You were not buying Equity National shares, isn't that true?
>
> A I wasn't buying Equity National.
>
> Q Mr. Arnold was going to use that money in his securities deal, isn't that correct?
>
> A Right. (241a)

Plaintiff Kupferman's trial testimony was to the same effect (293-294a).

> "The evidence, particularly the March 3 letter, left no room for doubt that Arnold and Fowler had pledged the Equity National shares to Mallis and Kupferman, thus creating a seller-purchaser relationship between those two sets of parties." (A12)[5]

It has been obvious throughout this case, on the pleadings which were before the Court of Appeals in *Mallis I* as well as on the trial evidence before it in *Mallis II*, that Mallis and Kupferman did not actually purchase the Equity National shares but rather accepted a collateral pledge of them from Arnold and Fowler. The holding in *Mallis II* that a "seller-purchaser relationship was created between these parties" is thus not a factual finding but rather the reaffirmation of *Mallis I's* legal conclusion that Mallis and Kupferman's acceptance of the pledge of Equity National shares should be deemed a "purchase" by them of the securities for the purposes of Section 10(b) and Rule 10b-5. It is that legal conclusion of the Second Circuit, disputed by Bankers Trust at every step of this litigation, which it again seeks to bring to this Court for review.

5. The March 3 letter referred to by the court in *Mallis II* is the identical letter to which Justice Nadel of the New York Supreme Court referred when he said in *Mallis* v. *Kates*, a related case, that "*He [Mallis] was not even a purchaser of the shares*, according to the letter agreement with Arnold." (emphasis added) (A67) Holding that Bankers Trust had no duty under New York law to tell plaintiff Mallis anything about the Equity National shares, Justice Nadel said:

> "The leading case on where there is a duty to speak is *Amend* v. *Hurley*, 293 NY 587, which holds that barring a fiduciary or confidential relationship there is no duty to speak. Plaintiff [Mallis] had absolutely *no* relationship with defendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter agreement with Arnold. No matter what he chooses to call his 'participation' in this 'investment', the Equity shares are called 'collateral' and he is guaranteed *repayment* out of another stock transaction." (emphasis by the court) (A69)

It is thus clear as a matter of New York law that the relationship created between Mallis and Arnold by the March 3 letter was one of pledgee-pledgor, and was *not* one of purchaser-seller.

The *Mallis II* opinion departs from *Mallis I* in one respect which is significant from the standpoint of framing the issue for review by this Court. In *Mallis II* the Court of Appeals recognized, as the *Mallis I* panel did not, that Bankers Trust's release of its pledge from Kates was not a "sale" to the plaintiffs. What happened, rather, as the *Mallis II* court said, was that "Bankers Trust released its pledge of the Equity National stock to the Kates upon receiving payment of its loan, the Kates then sold the stock to Arnold, and the latter pledged it to [Mallis and Kupferman]." (A12)[6] Thus the single critical legal question has now been isolated and is presented in sharp focus for review: was the Second Circuit correct in holding that an ordinary collateral pledge of securities, given to secure the repayment of an advance of monies, should be treated as a purchase of the securities (by the pledgee) and a sale of them (by the pledgor) for the purpose of conferring standing to sue under Section 10(b) and Rule 10b-5?

B. A Direct Conflict Exists Among The Circuits on The Question Presented Here.

The issue presented here is the subject of a direct conflict among the Second and Sixth Circuits, on the one hand, and the Fifth and Seventh Circuits, on the other. The Second Circuit line of cases, led by *Mallis I*, was expressly adopted by the Sixth Circuit in *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979). The opposing view is that

6. The Court of Appeals in *Mallis II* left for a subsequent trier of fact to determine whether, assuming Mallis and Kupferman were "purchasers", the conduct of Bankers Trust of which they complain was committed "in connection with" their purchase. Judge Carter in the District Court was disposed to direct judgment in Bankers Trust's favor on this point in light of Mallis' testimony that he had asked for the pledge of the Equity National shares only *after* he had agreed to advance the $156,000 to Arnold (288-294a; 511-512a). Since the jury returned its verdict for Bankers Trust, Judge Carter did not finally rule on this point. Petitioner continues to urge, however, that there is no evidence in this case upon which a jury could find that Bankers Trust committed any act "in connection with" Mallis and Kupferman's acceptance of the pledge from Arnold and Fowler.

taken by the Fifth Circuit in *McClure* v. *First National Bank of Lubbock*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) and in other cases culminating in *National Bank of Commerce* v. *All American Assurance Co.*, 583 F.2d 1295 (5th Cir. 1978), and which was followed by the Seventh Circuit in *Lincoln National Bank* v. *Herber*, 604 F.2d 1038 (7th Cir. 1979).

The Second Circuit based its holding in *Mallis I* that a pledge is a "purchase or sale" upon its earlier decisions in *United States* v. *Gentile*, 530 F.2d 461 (2d Cir.), *cert. denied*, 426 U.S. 936 (1976) and *SEC* v. *Guild Films Co.*, 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960), both cases arising under the Securities Act of 1933, 15 U.S.C. §77a *et seq.* In *Guild Films*, where the trial court had found that the pledge had been used as a device to avoid the registration of securities, the Court of Appeals held that the pledgees were "person[s] who [have] purchased from an issuer" within the statutory definition of an "underwriter" in Section 2(11) of the Act. In *Gentile* the defendant was charged in a criminal prosecution with having conspired to pledge fraudulently issued securities in violation of Section 17(a) of the 1933 Act. The Second Circuit concluded that the pledge was a "sale" by the pledgor within Section 2(3)'s definition of that word, "in the offer or sale of any security". Rejecting the Fifth Circuit's decision in *McClure*, the *Gentile* court reasoned that a pledgee assumes an "investment risk" in the pledged securities:

> "In effect, the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as the indisputable basis for statutory regulation of securities transactions. We therefore find no reason to treat the equivalent risks differently under the statute." 530 F.2d at 467.

In *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979), an investor alleged that a broker had fraudulently refused to return corporate bonds which the investor had pledged with the broker. The Sixth Circuit, noting "a split of authority on the question", followed *Mallis I* and *Gentile* to hold that a pledge is a "purchase or sale" as those terms are used in Section 10(b) and Rule 10b-5. 598 F.2d at 1028.

In opposition to the view of the Second and Sixth Circuits, the Fifth Circuit in *McClure* v. *First National Bank of Lubbock*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975), held that a plaintiff pledgor was not a "seller" with standing to sue a pledgee bank under Section 10(b). The court said:

> "If the bank sells stock pledged as loan collateral, it might then be subjected to liability in connection with the sale if it does not meet the requirements of the anti-fraud provisions of the securities acts, but mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not, of itself, bring within the scope of the federal securities acts a transaction otherwise outside their purview." 497 F.2d at 495.

In *National Bank of Commerce* v. *All American Assurance Co.*, 583 F.2d 1295 (5th Cir. 1978), where a pledgee bank attempted to sue its borrowers under Section 10(b), the Fifth Circuit held that "... the mere pledge of a security as collateral for a loan does not constitute a sale or purchase of a security within the meaning of the federal securities laws ...." 583 F.2d at 1300. In reaching this conclusion the court relied on its prior decisions in *McClure*, in *Reid* v. *Hughes*, 578 F.2d 634, 638 (5th Cir. 1978) (holding that the pledge of a security as collateral for a loan evidenced by a promissory note does not constitute a "purchase") and in *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970) (holding

that the corporate guarantor of a pledgor is not a "purchaser", reasoning that a transaction whose object is an extension of credit on the pledgor's behalf "is not the type of fraudulent conduct which was meant to be forbidden ...." 430 F.2d at 812). *National Bank of Commerce* recognized that "*Gentile* and *Mallis* ... can hardly be distinguished from the facts in the instant case and are contrary to the decision reached here ....", but rejected the "investment risk" rationale of those cases, saying:

> "This rationale might be a persuasive argument that the federal securities laws ought to encompass pledges, as well as purchases and sales. It does little to support a decision that they in fact do cover pledges. Congress can be presumed to know the difference between a collateral pledge transaction and a sale and purchase. If it had intended to cover both, it could have easily done so by words traditionally used to differentiate between the two." 583 F.2d at 1299-1300.

Most recently, *Mallis I* was expressly rejected and the Fifth Circuit's view in *National Bank of Commerce* adopted by the Seventh Circuit in *Lincoln National Bank* v. *Herber*, 604 F.2d 1038 (7th Cir. 1979). Here, the Court of Appeals reversed the district court's holding, which was based on *Mallis I*, that a borrower's pledge to a bank had been a "sale" and, reasoning from this Court's decisions in *Teamsters* v. *Daniel*, 439 U.S. 551 (1979) and *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, (1975), concluded that *National Bank of Commerce* was correct because it, unlike *Mallis I*, interpreted the statute in light of the economic substance of the transactions in issue. The reality of the transaction, the *Lincoln* court said, was that

> "... [the pledgee bank] sought to lend money on the security of certain stocks, not to invest in those stocks; and the purpose of the 1933 and 1934 Acts is to protect investors, not secured lenders such as Lincoln." 604 F.2d at 1041.

C. Neither the Language of the Statute, Nor the Intent of Congress, Nor Sound Policy Support the Second Circuit's Extension of Section 10(b) to the Entire Universe of Loan Transactions Collateralized by Securities.

The Second Circuit's decision here extends the general anti-fraud provisions of the federal securities acts to reach all loan transactions which happen to be collateralized by securities. According to the Second Circuit, every borrower and every lender in such a transaction now has, in addition to his other remedies, a claim for damages under Section 10(b) against any person who he can claim committed wrongdoing "in connection with" his loan. The impact of this holding is apparent, not only upon loan transactions between individuals such as Mallis and Arnold, but also upon commercial banking and financing activity throughout our economy generally. This impact warrants review by this Court.

The Second Circuit's judicial expansion of Section 10(b) here cannot be reconciled with this Court's insistence, in recent cases which have refused to expand that section's scope, that "The starting point in every case involving construction of a statute is the language itself." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976); *Teamsters* v. *Daniel*, 439 U.S. 551, 558 (1978); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring). "The critical phrase in both the statute [Section 10(b)] and the Rule [10b-5] is *'in connection with the purchase or sale of any security.'* " *Blue Chip Stamps, supra* at 756 (emphasis in the original). These words are entitled to be given their "commonly accepted meaning", *Ernst & Ernst* v. *Hochfelder, supra* at 199. The taking of a pledge is not the same as a purchase, and there is no reason to believe that Congress in adopting Section 10(b) intended its scheme for the regulation of the purchase and sale of securities to include pledges as well. The 1934 Act was "chiefly concerned with the regulation of post-distribution trading

on the Nation's stock exchanges and securities trading markets". *Blue Chip Stamps, supra* at 752. The pledgor-pledgee relationship, however, does not touch upon these concerns, and a pledge (whether of securities or of a diamond ring) is, in substance, a secured loan transaction governed by a complex framework of state commercial law. As Professor Loss has said, "federal legislation was hardly needed for privately negotiated pledge transactions between borrowers and lenders." 1 Loss, *Securities Regulation* 649 (2d ed. 1961). Like the cooperative apartment shares in *United Housing, Inc.* v. *Forman* and the pension plan in *Teamsters* v. *Daniel*, the economic substance of a privately-negotiated pledge arrangement is outside the ambit of Section 10(b).

This Court's approach to defining the scope of Section 10(b), which begins with the words of the statute and then moves to Congressional intent and the economic purpose of the transactions sought to be regulated, stands in sharp contrast to the approach of the Court of Appeals in this case. Neither in *Mallis I* nor in *Mallis II* was the language of Section 10(b) considered, and the sole reasoning offered to justify conferring standing on pledgees and pledgors to sue as purchasers or sellers was the assertion in *United States* v. *Gentile* that "there is no reason to doubt that Congress intended the [1933 Act] to protect defrauded lenders just as much as defrauded buyers." 530 F.2d 461, 467. That assertion is wrong; it contradicts what this Court and every other court has said about the federal securities acts; it forms the sole basis for giving pledgees and pledgors in commercial loan transactions the right to maintain suit pursuant to Section 10(b), and it should not be permitted to stand.

D. Dismissal of the Section 10(b) Claim Would Be Dispositive of This Action, Since The Remaining State Claims Could -- And Should -- Then Be Dismissed For Lack of Jurisdiction.

Invoking pendent jurisdiction, Mallis and Kupferman also sued Bankers Trust in this action for common law fraud and "negligent misrepresentation" under New York law. The Second Circuit in *Mallis II*, finding errors in the trial court's charge, held that a new trial was required of both state and federal claims and also held that the District Court had erred in refusing to charge the jury that plaintiffs might recover for "negligent misrepresentation" under New York law. This reading of New York law is highly uncertain and probably wrong. Even the Court of Appeals recognized that its conclusion that a New York court would recognize a claim for "negligent misrepresentation" on the facts of this case was a mere "prediction" (A32) — a prediction, indeed, that a New York court would overrule the forty-nine year old landmark opinion of Justice Cardozo in *Ultramares* v. *Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), the soundness of which has never even been questioned by a New York state court. Further doubt is cast upon the Court of Appeals' "prediction" by the decision of Justice Nadel of the New York Supreme Court in *Mallis* v. *Kates* on the facts of this very case that, as there was no relationship between Bankers Trust and plaintiff Mallis, Bankers Trust owed Mallis no duty of care (A69).

This uncertainty, and this intrusion upon state concerns, is as unnecessary as it is unsound. If the federal claims are dismissed on the grounds urged by this petition, the entire action should be dismissed.

United Mineworkers v. *Gibbs*, 383 U.S. 715, 725 (1966), recognized that pendent jurisdiction "in the sense of judicial power" requires that there be a substantial federal claim and that the relationship between that claim and the state claim be such as to comprise one constitutional case. See also *Hagans* v. *Lavine*, 415 U.S. 528, 536-538 (1974).

Where the lack of a federal claim may be established without resolution of factual disputes – i.e. where dismissal would be appropriate under Rule 12 or upon motion for summary judgment, there is no federal claim to which a state claim be "pendent", and federal jurisdiction is lacking. *Tully* v. *Mott Supermarkets, Inc.*, 540 F.2d 187 (3rd Cir. 1976); *Crane Co.* v. *American Standard, Inc.*, 603 F.2d 244 (2d Cir. 1979) (dictum). If this Court agrees with petitioner here that a pledge of securities cannot be equated as a matter of law with a "purchase or sale" under Section 10(b), then there is no substantial federal claim to which state claims might be appended. The mere circumstance that a Court of Appeals has twice misperceived this legal principle should not confer a jurisdiction which has been lacking since this litigation's inception. Nor does this misconception justify remanding for retrial in a federal court state claims which, but for the presence of the insubstantial federal claim, would never have been in federal court to begin with.

In *Tully* v. *Mott Supermarkets, Inc.*, 540 F.2d 187 (3rd Cir. 1976), the Third Circuit applied this jurisdictional test in circumstances very similar to those presented here. The court in *Tully*, having reversed a judgment for plaintiffs on the ground that they were not purchasers or sellers of a security, dismissed the pendent state claims for lack of jurisdiction even though the district court had granted judgment for the plaintiffs on those claims on a full factual record. In so holding, the court recognized that the plaintiffs' lack of standing to sue under the federal securities laws was the type of defect which rendered the federal claim insubstantial for jurisdictional purposes:

> "Plaintiffs' lack of standing to sue under Rule 10b-5 was a threshold bar which precluded them from stating in their complaint a cognizable claim for relief under the federal securities laws. As a consequence, their complaint could not have withstood a motion to dismiss for failure to state a claim under

> F.R. Civ. P. 12(b)(6). That this defense was raised in defendants' answer rather than by motion is of no moment. Under either alternative the absence of a substantial federal claim for relief should have been apparent on the basis of the pleadings at an early stage in the proceedings. Since there was no substantial federal claim to which the state claims could be appended, the primary justification for the exercise of pendent jurisdiction was absent. Accordingly, the claims should have been dismissed." 540 F.2d at 196.

Whether it be lauded as imaginative or condemned as imaginary, the Court of Appeals' interpretation of New York law in this case was unquestionably novel, difficult and uncertain. Considerations of fairness and federalism favor avoidance of such needless intrusions into state law by use of pendent jurisdiction. *United Mineworkers* v. *Gibbs*, *supra* at 726; *Aldinger* v. *Howard*, 427 U.S. 1 (1976). Unlike the situation where a state law judgment is affirmed, *see, e.g. Arizona* v. *Cook Paint & Varnish Co.*, 541 F.2d 226 (9th Cir. 1976), *cert. denied*, 430 U.S. 915 (1977), dismissal of the federal claim here would leave for retrial in a federal court nothing but a questionable state law claim. Thus, in this case no considerations of judicial economy, a central purpose of pendent jurisdiction, favor retention of the novel state law claims in the federal courts.

CONCLUSION

Bankers Trust Company's petition for a writ of certiorari should be granted.

Dated: New York, New York
March 14, 1980

Respectfully submitted,

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 241—September Term, 1979.

(Argued October 25, 1979

Decided January 25, 1980.)

Docket No. 79-7416

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs-Appellants,

—v.—

BANKERS TRUST CO.,

Defendant-Appellee and
Third Party Plaintiff-Appellee,

—v.—

JEROME B. KATES,

Third Party Defendant,

and

JACK J. ARNOLD,

Third Party Defendant-Appellee.

Before:

FRIENDLY, OAKES and NEWMAN,
Circuit Judges.

Appeals by plaintiffs from a judgment of the District Court for the Southern District of New York, Robert L. Carter, *Judge,* in favor of defendant Bankers Trust Company after a jury trial in an action for damages incurred in a securities transaction. Reversed and remanded.

PETER M. COLLINS, Esq., New York, N.Y. (White & Case, New York, N.Y., Richard G. Greco, Esq., Of Counsel), *for Defendant and Third Party Plaintiff-Appellee.*

NOEL HAUSER, Esq., New York, N.Y. *for Plaintiffs-Appellants.*

FRIENDLY, *Circuit Judge:*

Appellants Samuel Mallis and Franklyn Kupferman brought this action in the District Court for the Southern District of New York to recover losses allegedly suffered as the result of a somewhat unusual securities transaction. In addition to appellee Bankers Trust Company, the original defendants included the Federal Deposit Insurance Corporation and the European American Bank as successor-in-interest to Franklin National Bank. The district court, Milton Pol-

lack, *Judge,* dismissed appellants' claims against all defendants, *Mallis v. F.D.I.C.,* 407 F.Supp. 7 (S.D.N.Y. 1975), holding, *inter alia,* that appellants failed to state a claim against Bankers Trust under the Securities Act of 1933 becuase they were not purchasers of securities, and, for the same reason, denying appellants leave to amend their complaint to assert a claim under §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. On appeal, this court reversed the Securities Exchange Act holding and remanded with instructions to allow appellants leave to amend their complaint against Bankers Trust. *Mallis v. F.D.I.C.,* 568 F.2d 824 (1977), *cert. dismissed as improvidently granted,* 435 U.S. 381 (1978) (hereafter *Mallis I*).

Appellants' amended complaint filed solely against Bankers Trust, asserted a claim under §10(b) and Rule 10b-5 as well as pendent state law claims of fraud and negligent misrepresentation. Bankers Trust brought third-party complaints against Jerome B. Kates and Jack J. Arnold, a third-party appellee. The case was tried before Judge Carter and a jury which returned a verdict in favor of Bankers Trust on the Rule 10b-5 and fraud claims; the judge had declined to submit the claim of negligent misrepresentation. Mallis and Kupferman (sometimes collectively referred to as Mallis) appeal from the judgment in favor of Bankers Trust entered on this verdict, alleging, *inter alia,* error in the district court's treatment of their Rule 10b-5 claim and pendent common law fraud claim, and in its refusal to submit the pendent claim of negligent misrepresentation. Finding errors in the handling of all three claims, we reverse and remand for a new trial.

I. *The Facts*

The case revolved around 40,384 unregistered "conditional" shares of stock of Equity National Industries, Inc. (Equity National) issued on August 7, 1970 to Jerome and Judith Kates as the result of a merger between Equity-Take Two, Inc., a wholly-owned shell subsidiary of Equity National, and Take Two, Inc., a corporation owned by the Kates. The merger plan and appended Escrow Agreement provided that if the surviving Take Two corporation failed to meet certain earnings requirements, the conditional Equity National shares issued to the Kates were subject to recall for cancellation in whole or in part. In particular, if Take Two failed to show any net earnings for the 1970 calendar year, the Kates' entire block of conditional Equity National stock must be returned. A typewritten legend on the back of the two certificates representing the Kates' shares of Equity National warned that they were

> subject to the terms of an Escrow Agreement dated August 7, 1970 . . ., and may not be sold, transferred, pledged or hypothecated except in accordance with such Escrow Agreement, a copy of which may be examined at the office of the Corporation.

In fact, the surviving Take Two corporation showed a net loss for the 1970 calendar year and filed a petition in bankruptcy on February 18, 1971.

Before the facts with respect to Take Two's 1970 performance were known, Bankers Trust accepted the Kates' conditional Equity National shares as collateral on several short-term loans to them aggregating

$65,000. The first of these loans was made with a copy of the Escrow Agreement in hand, but was concluded in reliance on a rosy letter from Jerome Kates' attorney. By early 1971 these loans began to sour. Beginning in February or March of 1971, Bankers Trust assigned the Kates' account to a house attorney, Nathan Silverman for collection purposes. In letters dated March 1, March 4, and April 14, 1971, Bankers Trust received increasingly urgent requests from Equity National demanding the return of the Kates' stock pursuant to the terms of the Escrow Agreement because of Take Two's 1970 loss. On the other side, in a letter dated April 21, 1971, the Kates through their attorneys threatened legal action if Bankers Trust returned the disputed stock to Equity National. In a letter dated May 21, 1971, Silverman formally denied Equity National's request. On June 3, 1971, however, Bankers Trust brought an action against the Kates for repayment of the three overdue notes, and on July 15, 1971, it obtained a confession of judgment for $68,000 and an agreement from the Kates to a "workout" that permitted gradual repayment of their notes over a period exceeding ten years. Bankers Trust continued to hold the certificates for the Kates' Equity National shares.

Plaintiffs were not involved in any of the transactions recited up to this point. On February 3, 1972, John Fowler, a broker specializing in the placement of unregistered securities, learned that Jerome Kates possessed a large block of Equity National stock and was also said to hold a block of unregistered shares in Merck & Co., the blue-chip international pharmaceutical manufacturer. Fowler testified by deposition that he was informed that Kates was willing to sell his unregistered shares in both companies, but that the

sale of the Equity National shares, by far the less attractive, would have to close first. In early February 1972, Fowler contacted Kates to confirm the availability of the two blocks of stock; he also contacted Jack J. Arnold, the third-party defendant-appellee in this case, who was an associate and an experienced attorney. Arnold expressed interest in the Kates' stock, and, on February 24, 1972, after several conversations with Kates, entered into two contracts: an agreement to purchase the entire block of Equity National shares for $181,000 (of which he paid $25,000 immediately), and a 30-day option to purchase 110,000 unregistered shares of Merck & Co. at 60% of market price. Arnold testified that he and Fowler had planned to split the profits from the resale of the Merck stock. In addition, Arnold testified that he did not learn of the restrictive legend on the back of the Equity National certificates until the closing of the Equity National purchase. Several calls that Fowler and Arnold placed to the National Bank of Georgia, Equity National's transfer agent, apparently failed to reveal any encumbrances on the Equity National stock other than those stemming from its unregistered status under the Securities Act of 1933. Arnold also testified that he saw only a Xerox copy of the front side of the Equity National certificates during the negotiations with Kates that led to the purchase agreement (the certificates themselves being held by Bankers Trust), but was assured by Kates that the reverse side contained nothing unusual. Arnold's continued ignorance of any restrictions on the Equity National stock after he signed the purchase agreement was contested by a portion of Fowler's deposition, introduced by Bankers Trust, in which Fowler claimed to have phoned the president of Equity Na-

tional on February 25, 1972, to have learned that Equity National would not honor the Kates' stock certificates, and to have informed Arnold of this unsettling conversation on the same day. Appellants objected to the introduction of this portion of Fowler's deposition at trial, and the district court instructed the jury to consider it only "to determine whether or not [Fowler's] telephone call or the telephone calls were in fact made." Arnold, it should be added, denied any knowledge of a telephone conversation between Fowler and the president of Equity National.

After the conclusion of the purchase agreement and option contract between Arnold and Kates, Arnold and Fowler began to search for a way to raise the funds to close the Equity National deal. It was this search that brought Mallis and Kupferman into the transaction. Arnold was attorney for Mallis, a dentist, in an unrelated securities matter. On March 1, 1972, during the course of a meeting about this, Arnold revealed to Mallis the broad outlines of the pending deal with Kates. He informed Mallis that he stood to lose his $25,000 deposit on the Equity National purchase agreement unless he could raise $156,000 for the closing of the agreement scheduled two days later; he indicated that he or his clients would soon be in a position to make some $800,000 (without mentioning the Merck shares by name); and he offered a $50,000 fee for short-term financing of his Equity National purchase. Mallis conveyed this information to his brother-in-law, Kupferman, also a dentist, who in turn contacted John Murfitt, then an Assistant Vice President of Franklin National Bank and manager of the Uniondale branch of the Bank. Murfitt testified to having explored the possibility of lending Kupferman and Mallis the requi-

site funds by contacting Arnold and Silverman on March 2, 1972. Of these alleged conversations, the most critical was between Murfitt and Silverman. Murfitt claimed to have informed Silverman that appellants were interested in borrowing funds to finance the Equity National closing and, as the prospective lender, to have inquired about the availability, negotiability and registration of the Equity National stock. According to Murfitt, Silverman's reassuring response was that the stock was available, that it was "saleable," that the closing of the sale would be a brief and routine affair, but that the deal had to be closed within twenty-four hours. Silverman denied any such conversation. After this brief investigation, Murfitt agreed that Franklin National would advance Mallis and Kupferman the necessary $156,000 providing that they alone would assume total responsibility for its repayment. Murfitt, with appellants' knowledge, falsely characterized the purpose of Franklin National's loan to appellants as financing for a real estate transaction.

On the morning of March 3, the day set for the closing, appellants obtained their loan from Franklin National. In addition, Arnold telephonically communicated to Mallis—and Mallis approved—a letter purporting to confirm the understanding between Arnold and Fowler as to appellants' "participation" in the Equity National transaction.[1]

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1 This letter, which Mallis received after the closing, related that Mallis was to "advance" $156,728 toward the total purchase price of $181,728 of the Equity National shares, $25,000 of which had already been paid; that Mallis was to receive those shares as "collateral"; that within thirty days or less, Mallis was to be "reimbursed" for his initial outlay plus a "profit" of $50,000; that after remittance of his "investment" of $156,728 plus the $50,000 profit, Mallis was to return the Equity National shares to Arnold; and that the money "accruing" to Mallis would be paid from the proceeds of a sale of 100,000 shares of Merck & Co. stock in March, 1972.

Appellants did not attend the closing but were represented by Arnold, Murfitt, or both Arnold and Murfitt, depending on whose testimony is credited. Murfitt arrived at the closing with three checks representing the funds lent to appellants by Franklin. Besides Murfitt, the other participants in the closing included Arnold, Fowler, Kates and Silverman. The closing was held on the premises of Bankers Trust in a conference room near Silverman's office.

The trial testimony as to what transpired during the closing was contradictory on all but a handful of major points. Acting for Bankers Trust, Silverman produced the Equity National certificates from a file that contained some or all of the correspondence addressed by Equity National to Bankers Trust and that may have contained a copy of the Escrow Agreement, see note 2 *infra*. Upon reading the typewritten legend on the back of the Equity National certificates, Arnold inquired about the Escrow Agreement mentioned in the legend. Kates could not produce a copy of the Agreement. A discussion about the meaning of the legend then ensued. Kates assured Arnold that the requirements of the Escrow Agreement had been met and no restrictions on the stock remained; someone suggested that Kates sign an affidavit to that effect; an affidavit was dictated to Silverman's secretary by either Arnold alone or Arnold and Silverman jointly; Kates signed the affidavit; and Murfitt handed over the checks to Kates, including a check for $45,000 which Kates endorsed to Bankers Trust in partial satisfaction of the Kates' outstanding debt. During the closing Silverman never mentioned the Equity National correspondence that he kept in the same file with the stock certifi-

cates.[2] At issue during the trial were the extent of Silverman's knowledge of the terms and significance of the Escrow Agreement; the extent of his participation in dictating the affidavit signed by Kates; and whether, as Arnold and Murfitt alleged, Silverman affirmatively represented the Equity National stock as unencumbered apart from restrictions imposed by lack of registration. The closing ended with Bankers Trust having been repaid $45,000, or the bulk of its then outstanding loan to the Kates, with the Kates receiving the balance of $111,728, and with Mallis and Kupferman holding the 40,384 shares of Equity National as collateral for the payment by Arnold and Fowler of their "investment" of $156,728 and a $50,000 profit. Unknown to the other participants in the transaction, Fowler subsequently received a $10,000 fee from Kates for his services.

It soon developed that Kates never possessed the 100,000 unregistered shares of Merck & Co. specified in his option contract with Arnold, the sale of which

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2 At trial, Silverman could recall reading only the last of the three letters from Equity National, dated April 14, 1971, which requested the return of the Equity National certificates. This letter made no mention of the Escrow Agreement but referred only to earlier correspondence, dated March 1 and March 4, 1971, that supported Equity National's claim on the stock. The March 1 letter referred to the terms of the Escrow and merger agreements; the March 4 communication served as a cover letter accompanying copies of these agreements, which were submitted at the request of Bankers Trust. Silverman acknowledged on cross-examination that the file he carried at the closing probably included copies of all correspondence regarding Equity National that had been received by the Delancey Street branch of Bankers Trust—a category that presumably included both the March 1 and March 3 mailings from Equity National. Silverman also recalled having read the Escrow Agreement during March or April of 1971, but testified that he had been assured by both Kates and a Bankers Trust loan officer that Kates had met the conditions of that agreement.

was to generate the funds to reimburse appellants, and that the Equity National conditional shares were worthless. After the discovery of his fraud, Kates paid Arnold $50,000 which Arnold then paid over to appellants. Arnold and Fowler also contributed an additional $5,135 toward appellants' interest payments on their Franklin National loan. Apart from this, appellants remain out-of-pocket on their payment to Kates, $106,000. In this action they sought recovery of $156,000 on their Rule 10b-5 claim and $206,000 on their state law claims, together with $500,000 in punitive damages, interest and counsel fees.

II. *The Rule 10b-5 Claims*

Appellants make several claims of error in the court's handling of the Rule 10b-5 claim:

The first is that the court erred in charging that in order to recover under Rule 10b-5 the plaintiff must show "that the untrue statement or omission was made in connection with the sale of the shares of Equity National Industries, Inc.". Appellants contend, as they did during the trial, that this issue was conclusively determined in their favor by this court's previous decision, 568 F.2d at 828-30. We do not think our prior decision went so far. It held that plaintiffs should be allowed to amend their complaint to set forth a claim under Rule 10b-5 since as a matter of law a pledge might constitute a sale by the pledgor and a purchase by the pledgee,[3] not that the proofs at a new trial

3 We further said, 568 F.2d at 830:

> Appellants were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge.

(footnote continued on next page)

would necessarily demonstrate such a purchase or sale here. The evidence, particularly the March 3 letter, left no room for doubt that Arnold and Fowler had pledged the Equity National shares to Mallis and Kupferman thus creating a seller-purchaser relationship between those two sets of parties. It was not at all clear, however, that such a relationship existed between Bankers Trust and the plaintiffs, as appellants apparently recognized in their argument before the Supreme Court, see note 3 *supra*. What happened was that Bankers Trust released its pledge of the Equity National stock to the Kates upon receiving payment of its loan, the Kates then sold the stock to Arnold, and the latter pledged it to appellants. Appellants' strongest ground for asserting liability of Bankers Trust under Rule 10b-5 would thus seem to be, as the SEC argued before the Supreme Court, that its deception was "in connection with" appellants being purchasers as a result of having accepted the pledge of the Equity National shares as security for their "investment." *Mallis I* had not ruled on that precise issue and, while the district court's general instruction that the jury must determine whether appellants had engaged in a purchase or sale of securities left a good deal to be desired, counsel for appellants, who was consistently unhelpful to the district court, suggested no better one.

In the Supreme Court appellants disavowed this and "took the position that the mere release of a pledge is [not] a sale" at all, see 435 U.S. at 388. It was this change in theory that led the Court to dismiss the writ as improvidently granted. In any event we do not believe the quoted language, written in the absence of detailed proof of what occurred, can mean that this court committed itself to the view that there was a sale from Bankers Trust to appellants no matter what the evidence might show. On the record before us no such transaction existed.

Appellants' second criticism is that the judge improperly allowed the jury to consider a defense of "unclean hands" or *in pari delicto* even though such a defense was never formally charged to the jury.[4] Appellants' sins are claimed to be twofold. One is that, with their knowledge, Murfitt falsely characterized the purpose of Franklin National's loan to them as financing for a real estate transaction in violation of 18 U.S.C. §1005. The other is that appellants' transaction with Arnold and Fowler was usurious loan in violation of New York Penal Law §190.40, since the $50,000 profit in one month would have amounted to interest at an annual rate of 384%.

Appellants' alleged wrongdoings do not bar their common law claims of fraud and negligent misrepresentation, discussed below, since New York law ordinarily permits an unclean hands defense only when plaintiff's reprehensible conduct is "directly related to the subject matter in litigation and the party seeking to invoke the [unclean hands] doctrine was injured by the conduct." *Weiss v. Mayflower Doughnut Corp.*, 1 N.Y.2d 310, 318, 152 N.Y.S.2d 417, 474, 135 N.E.2d 208, 210 (1956). See, e.g., *National Distillers Corp. v. Seyopp Corp.*, 17 N.Y.2d 12, 15-16; 267 N.Y.S.2d 193, 194-96; 214 N.E.2d 361, 362-63 (1966); *Dinerstein v. Dinerstein*, 32 A.D. 750, 750-51, 300 N.Y.S.2d 677, 678-79 (1st Dep't. 1969); *American Cyanamid Co. v. Power Conversion, Inc.*, 71 Misc. 2d 213, 214-15, 336 N.Y.S.2d 6, 9 (Sup. Ct. Westchester Co. 1972). Here, appellants' supposedly wrongful actions do not possess the requisite connection to the subject matter in litiga-

4 Bankers Trust raised this defense against all three of appellants' claims. For convenience we shall discuss them together.

tion, i.e., alleged misrepresentations by Bankers Trust regarding the restrictions on the Equity National stock certificates. Cf. *National Distillers and Chemical Corp. v. Seyopp Corp.* (alleged violation of alcoholic beverage control law no bar to injunctive relief under fair trade law), *supra; American Cyanamid Co. v. Power Conversion, Inc.* (alleged fraud in obtaining patent no bar to claim of misappropriating trade secrets), *supra. See generally* 20 N.Y. Jur. Equity §110 at 136-37, §112 at 139-40 (1976 ed.). Still more persuasive, Bankers Trust was in no way injured by appellants' allegedly wrongful conduct, and thus may not invoke the unclean hands defense. See cases cited above; 20 N.Y. Jur., *supra,* §111 at 138-39; 2 Pomeroy, *Equity Jurisprudence* §399 at 94-99 (5th ed. 1941).[5] Finally, Bankers Trust has failed to meet a third condition for invoking the unclean hands defense under New York law, namely, the requirement of equal guilt. See *Furman v. Furman,* 178 Misc. 582, 586, 34 N.Y.S.2d 699, 704 (1941), aff'd, 262 A.D. 512, 30 N.Y.S.2d 516, aff'd 287 N.Y. 772, 40 N.E.2d 643; 20 N.Y. Jur., *supra,* §115 at 142-43. Even a cursory balancing of the competing charges suggests that, under the circumstances of this

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5 To be sure, New York courts have relaxed the injury requirement when a party seeks to enforce an inherently illegal arrangement or an agreement whose performance by one side is marred by gross illegality. See *McConnell v. Commonwealth Pictures Corp.*, 7 N.Y.2d 465, 199 N.Y.S.2d 483, 166 N.E.2d 494 (1960) (summarizing case law on illegal contracts and extending rule of nonenforcement to instances where contract performance was tainted by commercial bribery); *Palumbo v. Palumbo,* 55 Misc. 2d 264, 284 N.Y.S.2d 884 (1967) (Meyer, J.) (despite case law in other areas, uninjured defendant may invoke unclean hands defense when plaintiff seeks performance of agreement to recover property originally conveyed to defraud creditors). Appellants are not seeking the enforcement of a private agreement tainted by illegality; they are bringing an action in tort.

case, the degree of appellants' alleged misconduct falls short of the claims lodged against Bankers Trust. the same conclusion follows with respect to the defense to appellants' Rule 10b-5 claim. Bankers Trust has cited no authority for the proposition that illegal acts in assisting a buyer to assemble the funds needed for the purchase of securities or in exacting a forbidden price for such assistance constitutes a defense for a person who has violated Rule 10b-5 in causing the plaintiff to accept a worthless pledge. The Supreme Court has not displayed much enthusiasm for the *in pari delicto* defense to claims for violation of federal statutes even when the plaintiff's violation was of the same statute under which he sought relief. *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968) (antitrust laws). Decisions in this circuit have either rejected the *in pari delicto* defense to securities claims or have permitted it for a joint violation of the same statute—usually in actions brought under Rule 10b-5 by "tippees" against "tippers"—after lengthy analysis of underlying statutory objections and a finding that plaintiff's wrongdoing was no less than that of the defendant. For denials of the defense, see *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2 Cir. 1970) (violation of margin requirements); *Weitzman v. Stein*, 436 F.Supp. 895 (S.D.N.Y. 1977) (unwitting implication in fraudulent scheme); *Nathanson v. Weiss, Voisin, Cannon, Inc.*, 325 F.Supp. 50 (S.D.N.Y. 1971) (Weinfeld, J.) (tippee-tipper action); cf. *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2 Cir. 1969) (§12(1) of Securities Act of 1933). For decisions accepting the defense, see *In re Haven Industries, Inc.*, 462 F.Supp. 172 (S.D.N.Y. 1978) (tippee-tipper action); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F.Supp. 112

(S.D.N.Y. 1974), rev'd in p t on other grounds, 540 F.2d 27 (2 Cir. 1976) (1933 Act counterclaim by underwriter against accounting firm alleging liability for misleading report); *Wohl v. Blair & Co.*, 50 F.R.D. 89 (S.D.N.Y. 1970) (tippee-tipper action); *Serzysko v. Chase Manhattan Bank*, 290 F.Supp. 74 (S.D.N.Y. 1968), aff'd 409 F.2d 1360 (2 Cir.), *cert. denied*, 396 U.S. 904 (1969) (Regulation U, active deception on part of plaintiff). In the instant case, appellants' alleged delicts are insufficiently related to either the statutory violation at issue or the objectives underlying §10(b) to support an *in pari delicto* defense under decisions most favorable to the defendant. Moreover, Bankers Trust would fare no better under the precedents of other circuits where that defense has been viewed more favorably. See, e.g., *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3 Cir.), *cert. denied*, 434 U.S. 965 (1977); *Fogarty v. Security Trust Co.*, 532 F.2d 1029 (5 Cir. 1976); *Malamphy v. Real-Tex Enterprises*, 527 F.2d 978 (4 Cir. 1975).[6]

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6 These cases, like decisions within the Second Circuit approving the *in pari delicto* defense, cited *supra*, look to a conspiratorial or quasi-conspiratorial relationship between plaintiff and defendant, relatively equal culpability as between the parties, and whether allowing the defense will further the enforcement policies of the securities acts. The most widely cited "rule" for determining the availability of the defense was framed by *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 521 F.2d 225 (on petition for rehearing) (5 Cir. 1975), vacated on other grounds, 426 U.S. 944 (1976) (Wisdom, J.):

> the fault of the parties must be "clearly mutual, simultaneous, and relatively equal". [quoting *James v. Du Breuil*, 500 F.2d 155, 160 (5 Cir. 1974)] Moreover, the effect on the investing public or on the implementation of important features of the regulatory scheme must be so small as to permit the Court to conclude that allowing the defense would not interfere with "the objective of the securities laws [of] increasing the protection to be afforded to the investing public", as Judge Aldrich noted in *Kuehnert v. Texstar Corp.*, 412 F.2d 700, 704 (5 Cir. 1969).

Despite this we would not reverse for admission of the evidence in regard to the false statements in Franklin National Bank documents since the point was not properly made or preserved. Appellants' only objection to the extensive testimony of Murfitt, Mallis and Kupferman on the subject came at one point in the cross-examination of Mallis when counsel for Bankers Trust characterized the Franklin Bank's action as "misrepresentations" and appellants' counsel objected only to the "characterization". Although Bankers Trust's counsel stressed the point in summation, appellants neither objected nor asked the judge to charge the jury to disregard the argument.[7] Indeed appellants do not even complain of this in their brief. The case is otherwise, however, with respect to the usury claims, where plaintiffs strongly objected.[8]

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521 F.2d at 227; 515 F.2d at 604. In the instant case, the parties alleged wrongdoings most clearly lack the requisite "mutuality". They were unrelated in purpose, see *Woolf, supra*, 515 F.2d at 604, and they were not committed jointly or as the acts of confederates, see *Lawler v. Gilliam*, 569 F.2d 1283, 1291-93 (4 Cir. 1978) (following *Woolf* rule). The only case in which a court of appeals has even considered the possibility that an equal delict outside the ambit of the securities laws might block a Rule 10b-5 claim involved a collaborative offense, namely deception of a probate court that was an integral part of the course of conduct underlying the plaintiff's Rule 10b-5 claim. See *Fogerty v. Security Trust Co., supra.*

7 Prior to summations, appellants asked for, and were refused, an instruction to the effect that Franklin National was legally entitled to loan appellants funds for the purpose of financing the Equity National transaction. However, this failed to address the claim of misrepresentation to appellants' action against Bankers Trust.

8 Mallis and Kupferman were both questioned extensively about whether their roles in the Equity National transaction could be characterized as those of lenders; both were asked if they were aware of the state usury laws; and in summation, counsel for Bankers Trust stressed that the "interest" which appellants had planned to charge "might raise a question in ones' mind whether that transaction might be usurious." Appellants' counsel objected to the use of the terms "loan" and "interest" during the cross-examina-

In addition to the general reluctance to allow unrelated "bad" actions by plaintiffs as *in pari delicto* defenses, this would be a singularly inappropriate case for allowing usury as an *in pari delicto* defense. It is by no means clear that the transaction between appellants on the one hand and Arnold and Fowler on the other was a "loan" within §190.40 of the New York Penal Law. For a loan to be criminally usurious under that section, the alleged usurer must "knowingly" charge interest in excess of the legal rate. Appellants may well not have possessed the requisite criminal intent with respect to their $50,000 "profit" or "fee". Moreover, there is a strong presumption under New York law against a finding of usury. *Cusick v. Ifshin,* 70 Misc. 2d 564, 568, 334 N.Y.S.2d 106, 110-111 (Civ. Ct. New York Co. 1972), aff'd, 73 Misc.2d 127, 341 N.Y.S.2d 280 (1973). Even if appellants' participation was usury, however, Bankers Trust was in no way adversely affected by plaintiffs' greed. Without endeavoring to essay any comprehensive formulation of the status of the *in pari delicto* defense in cases of this sort, we thus hold it was error to allow this testimony to go to the jury, and we cannot say that the error was harmless. Even if the jury was not expressly charged that appellants' allegedly usurious scheme was a defense to their claims, the jury could well have considered the usury charge in the absence of cautionary instructions.

Although this error is sufficient to require reversal of the defendant's verdict on the Rule 10b-5 claim, we

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tion of Mallis and Kupferman. He repeated these objections during a colloquy over jury charges, and pointed out that the usury argument was a wholly spurious defense to appellants' claim even assuming *arguendo* that appellants' participation was a loan.

cannot avoid deciding the point most strongly pressed by appellants on this phase of the case since it will be bound to arise on a new trial. This was the judge's charge that appellants bore the burden of establishing their own "due diligence and good faith", which he defined as exercising "reasonable care and prudence to learn the facts about the securities before entering the transaction" given all the surrounding circumstances, and conducting "a reasonable investigation upon learning of the notice of the Escrow Agreement printed on the shares." In addition, Judge Carter requested that the jury consider whether appellants or their agents "possessed other information [besides the restrictive legend on the share certificates] which should have altered them to further investigation or caution." *Id.* While appellants' objections to the charge fell considerably short of perfection, we think they sufficed, although barely so, to call the propriety of this charge into question, as surely will be done at a new trial.

The argument is that since *Ernst & Ernst v. Hochfelder,* 425 U.S. 183 (1976), imposed a *scienter* requirement for a finding of liability under Rule 10b-5, requiring scrutiny of plaintiff's conduct under a traditional due diligence-negligence standard is no longer appropriate, particularly in light of the general absence of such a requirement in cases of common law fraud. Responsive to this argument, four courts of appeals have modified or abandoned evaluation of plaintiff's conduct under a reasonable man standard in Rule 10b-5 actions. See *Dupuy v. Dupuy,* 551 F.2d 1005, 1013-24 (5 Cir.) (Wisdom, J.), *cert. denied,* 434 U.S. 875 (1977) with Mr. Justice White dissenting from the denial on the ground that the standard announced in *Dupuy* differed from our statement in *Hirsch v. du*

Pont, infra; Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1048-49 (7 Cir.), *cert. denied*, 434 U.S. 875 (1977); *Holdsorth v. Strong*, 545 F.2d 687, 692-95 (10 Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 596-98 (3 Cir. 1976). Another circuit has signalled its rejection of the requirement. See *Holmes v. Bateson*, 583 F.2d 542, 559 n.21 (1 Cir. 1978). The most complete analysis is in *Dupuy*. That case, like *Straub* and *Holdsworth*, involved the alleged betrayal of a close relationship—plaintiff's sale of a 47% interest in a closed corporation to his brother. The *Dupuy* district court entered judgment N.O.V. for defendant on the ground that plaintiff failed to exercise due diligence. The Fifth Circuit reversed, determining that plaintiff's conduct ought to have been evaluated by a "reckless" standard. 551 F.2d at 1020. Its rationale for the new standard included *inter alia* an analogy to the tort distinction between plaintiff's duties in actions for fraud and for negligent misrepresentation; the assertion of a greater federal interest (loosely inferred from the history of the Securities Exchange Act) in deterring intentional misconduct than in deterring negligent misconduct by investors, *id.* at 1019; a diminished need to limit the scope of 10b-5 liability in the wake of *Ernst & Ernst;* and the observation "that most 10b-5 cases, when limited to their facts, are consistent with the distinction between intentional and negligent misrepresentation," i.e., they either held that plaintiff's negligence was irrelevant in light of defendant's intentional fraud, or they examined plaintiff's conduct under the negligence standard while failing to require *scienter* on the part of the defendant, a course no longer permissible under *Ernst & Ernst*. Following Prosser's definition of "wil-

ful", "wanton" or "reckless", *Dupuy* concluded that the appropriate standard for evaluating plaintiff's behavior in a Rule 10b-5 action was whether he

> intentionally refused to investigate in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow.

551 F.2d at 1020.

As against this Bankers Trust asserts that this circuit is committed to a contrary view by *Hirsch v. du Pont,* 553 F.2d 750, 762-63 (1977), and particularly by the statement that:

> The securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information.

Id. 763. Although district courts in this circuit have so held, see *NBI Mortgage Investment Corp. v. Chemical Bank,* [CCH] Fed. Dec. L. Rep. ¶96,066 at 91,799 (S.D.N.Y. 1977); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.,* 458 F.Supp. 1110, 1128 & n.12 (S.D.N.Y. 1978), rev'd on other grounds but with the opinion approving *Hirsch,* 602 F.2d 472, 486 (2 Cir. 1979) petition for certiorari filed, 48 U.S.L.W. 3457 (1980),[9] the quoted statement in *Hirsch* should be lim-

9 The facts in *Edwards & Hanly* would have led to dismissal under the *Dupuy* standard. Particularly apt is the late Judge Gurfein's quotation, slip opinions at 3407, from 2 Kent, Commentaries 485:

(footnote continued on next page)

ited to facts similar to those to which it was addressed, namely, where the comptroller of a large New York stock brokerage firm contemplating merger with another had received an answer to a questionnaire from the latter revealing "a possible massive capital deficiency" and failed to pursue the line of inquiry plainly suggested by this. This went far beyond negligence. The opinion did not discuss the bearing of *Ernst & Ernst* on a plaintiff's responsibility and the principal authority that was cited, *Rochez Bros., Inc. v. Rhoades,* 491 F.2d 402, 409-10 (3 Cir. 1974), *cert. denied,* 425 U.S. 993 (1976), a pre-*Ernst & Ernst* decision, had been greatly restricted in light of *Ernst & Ernst* ten months before the *Hirsch* opinion, by *Straub v. Vaisman & Co., Inc., supra,* 540 F.2d at 596-98. While we have no quarrel whatever with the result in *Hirsch* and *Edwards & Hanly* on the facts there presented, we hold that in the light of *Ernst & Ernst* a plaintiff's burden is simply to negate recklessness when the defendant puts that in issue[10], not to establish due care.

The common law affords to everyone reasonable protection against fraud in dealing, but it does not go to the romantic length of giving indemnity against the consequences of indolence and folly, or a careless indifference to the ordinary and accessible means of information.

10 Two commentators have urged that the defendants should have the burden not only of placing plaintiff's recklessness in issue but the ultimate burden of persuasion. See Wheeler, Plaintiff's Duty of Due Diligence Under Rule 10b-5: An Implied Defense to an Implied Remedy, 70 Nw. U.L. Rev. 561, 595-96 (1976); Note, a Reevaluation of the Due Diligence Requirement for Plaintiffs in Private Actions Under SEC Rule 10b-5, 1978 Wisc. L. Rev. 904, 922-24 (1978). Although perceiving the arguments for this position for the time being we are content with Judge Wisdom's formulation in *Dupuy.*

III. *The Court's Charge on the State Fraud Claim.*

The judge charged seven elements of common law fraud, each of which plaintiffs were required to prove by "clear and convincing evidence." Of these, element 4 was justifiable reliance and element 5 was "[t]hat the plaintiffs or their agents acted with due diligence and in good faith." He also charged that the elements of common law fraud were identical to those of the Rule 10b-5 claim, save for the absence of one element (misrepresentation in connection with a sale of securities), the need for proof of all elements by clear and convincing evidence, and a requirement of express misrepresentation rather than mere omission. Thus the jury was effectively told that in addition to establishing justifiable reliance, plaintiffs were required to prove due diligence in investigation as a separate element of a New York fraud claim just as the court had specified for the 10b-5 claim. Appellants contend that this was error.

The threshold question is whether appellants effectively objected to the due diligence charge. Appellants made no mention of due diligence in their requested jury charges. Their requested charge 28 required a jury finding that they "justifiably relied" on the representations of Bankers Trust, and their requested charge 33 stated that justifiable reliance depended on whether the fact represented was such that a reasonable man would consider it important to making a decision, or, alternatively, on whether the person making the representation knew that it would be relied upon even if it were not such a fact.[11] This portrayal of justifiable

11 Such language goes, of course, to materiality rather than the justifiability of reliance.

reliance closely follows a portion of the model charge presented in 2 N.Y. Pattern Jury Instructions—Civil, PJI 3:20 at 682-83 (1968). The judge announced that he was granting all but the second alternative of the reasonable reliance definition, i.e., the assertion that reliance might be justified if the person making the representation knew that it would be relied upon. After the charge appellants did not except to the court's introduction of due diligence as a separate element of the fraud charge, but did object to the statement that plaintiff had the burden of showing both due diligence and reliance. While plaintiffs' counsel could surely have done much better in apprising the court of the alleged error, we are inclined to think this was sufficient especially since there must be a new trial in any event.

Appellants are correct in their general assertion that New York requires proof of the traditional five elements of fraud: misrepresentation of a material fact, falsity of that representation, *scienter,* reliance and damages, see, e.g., *Jo Ann Homes v. Dworetz,* 302 N.Y.S. 2d 799, 803, 25 N.Y.2d 112, 119 (1969); 24 N.Y. Jur. Fraud & Deceit §14 at 47-48 (1962), and does not recognize a separate due diligence element, much less one that must be independently proved by clear and convincing evidence. However, it is not as clear as plaintiffs would have it that New York law does not sometimes introduce due diligence—not as a separate element for recovery of a fraud but as incidental to proof of justifiable reliance. Elsewhere the majority position is that plaintiff's negligence will not defeat a fraud claim, and *a fortiori* that plaintiff is not required to have conducted a due diligence investigation, see Prosser, Torts, §108 at 115-18, Restatement

(2d.) Torts §540, and this broad position is also supported by some New York authority. See *Hiliel v. Motor Haulage Co., Inc.*, 140 N.Y.S. 2d 51, 54 (Sup. Ct. Kings Co. 1955), aff'd 1 A.D.2d 782, 149 N.Y.S.2d 224 (2d Dep't 1956) ("The law does not ordinarily impose upon a person the duty of investigating fraudulent claims .... Even negligence in ascertaining the true facts has been held not to bar the right of recovery"); N.Y. Jr. Fraud & Deceit §176 at 248 (no duty of investigation). The bulk of New York authority, however, appears to follow a two-tier standard in determining plaintiff's duty, according to whether misrepresentations relate to matters that are, or are not, "peculiarly within the [defending] party's knowledge." When matters are held to be peculiarly within defendant's knowledge, it is said that plaintiff may rely without prosecuting an investigation, as he has no independent means of ascertaining the truth. 24 N.Y. Jur., *supra*, §176 at 247-48, indeed some cases have imposed liability in situations in which plaintiff could have determined the truth with relatively modest investigation. See, e.g., *Todd v. Pearl Woods, Inc.*, 20 A.D.2d 911, 248 N.Y.S.2d 975 (2d Dep't 1964), aff'd, 15 N.Y.2d 817, 257 N.Y.S. 937 (1965) (failure to check defendant's representations against public records no bar to fraud claim); *Albert v. Title Guarantee & Trust Co.*, 277 N.Y. 421 (1938) (failure to investigate land before accepting assignment of interest in mortgage no bar to fraud claim); *cf. National Conversion Corp. v. Cedar Bldg. Corp.*, 23 N.Y.2d 621, 298 N.Y.S.2d 499, (1969) (lawyer's failure to investigate misrepresentation of mixed question of fact and law no bar to client's recovery under fraud claim). By contrast, when

misrepresentations have been held to concern matters that were not peculiarly within the defendant's knowledge, New York courts have often rejected plaintiff's claim of justifiable reliance because

> [if plaintiff] has the means of knowing, by the exercise of ordinary intelligence, the truth, or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter the transaction by misrepresentation. [Citations omitted].

Schumaker v. Mather, 133 N.Y. 590, 598 (1892). See 24 N.Y. Jur., *supra,* §176 at 245-47. Decisions holding that reliance on misrepresentations was not justified are generally cases in which plaintiff was placed on guard or practically faced with the facts. See, e.g., *Danann Realty Corp. v. Harris,* 5 N.Y.2d 317, 184 N.Y.S. 2d 599 (1959) (buyer may not rely on misrepresentations in face of contract clause eschewing such reliance); *Sylvester v. Bernstein,* 283 A.D. 333, 127 N.Y.S.2d 746, aff'd, 307 N.Y. 778 (1954) (landlord may not rely on tenants' representation that apartment would not be used for residential purposes); *Cudemo v. Al & Lou Construction Co., Inc.,* 54 A.D.2d 995, 387 N.Y.S.2d 929 (3d Dep't 1976) (plaintiff taking possession of garage one week prior to signing after making frequent inspections was not entitled to rely on representations that garage would accommodate her car). This case falls within the first group of New York cases rather than the second. The facts were readily within Bankers Trust's knowledge—indeed the jury could permissibly have found that Silverman actually knew them all. In contrast appellants had been com-

plete strangers to the Equity National-Kates transaction. We thus hold the charge as to appellants' being obliged to establish due diligence as an element of their pendent fraud claim was reversible error.

IV. *Denial of Appellants' Negligent Misrepresentation Claim.*

The judge denied appellants' requested jury charge No. 36, which read in relevant part:

> Plaintiff's [sic] third claim is that Bankers Trust Company through Silverman was negligent in making the representation they made at the time of closing with respect to the status of the stock. One who makes a statement with knowledge that the statement is required for a serious purpose and with knowledge that it is made for the bene[fit] of another person who is expected to rely upon it and [who] may be damaged if it is false is under a duty to such other person (or the agent who represents him) to exercise reasonable care that the statement is correct.[12]

and refused to submit the issue of liability for negligent misrepresentation to the jury. Appellants excepted to the judge's actions.

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12 With minor changes, this requested charge recites the model charge set forth in 1 N.Y. Pattern Jury Instructions—Civil, PJI 2:30 at 542 (2 ed. 1974). See also *Bankers Trust Co. v. Steenburn*, 95 Misc. 2d 967, 991-92, 409 N.Y.S.2d 51, 66 (Sup. Ct. Chautauqua Co. 1978). Not all elements of negligent misrepresentation are included in the model charge. Whether a relationship exists between the parties that will bring the negligent misrepresentation doctrine into play, see discussion *infra*, is generally treated as a question of law for the courts. 1 N.Y. Pattern Jury Instructions, *supra*, PJI 2:30 at 544 (Comment).

During the colloquy over appellants' requested instruction, Bankers Trust made the same argument that it advances on appeal, namely, that New York does not recognize a negligent misrepresentation action without a fiduciary or contractual relationship between the parties. The district court accepted this argument and observed that a charge based on negligence would be impermissible "as a matter of law on the submission of evidence and the complaint."

The scope of the negligent misrepresentation action was defined for New York, and indeed, for the common law generally, by a series of decisions of the New York Court of Appeals during its golden age. *Glanzer v. Shepard,* 233 N.Y. 263 (1922) (Cardozo, J.); *International Products Co. v. Erie R.R. Co.,* 244 N.Y. 331 (1927) (Andrews, J.); *Courteen Seed Co. v. Hong Kong & Shanghai Banking Corp.,* 245 N.Y. 377 (1927) (Pound, J.); *Ultramares Corp. v. Touche, Nevin, & Co.,* 255 N.Y. 170 (1931) (Cardozo, J.). Recent years have seen some advance from *Ultramares, supra,* the most restrictive of these classic decisions. See *White v. Guarente,* 43 N.Y.2d 356, 362, 401 N.Y.S.2d 474, 478 (1977); Restatement (2d) Torts §552. The Court of Appeals there stated the basic elements of New York's negligent misrepresentation action to be:

> As to duty imposed, generally a negligent statement may be the basis for recovery of damages, where there is carelessness in imparting words upon which others were expected to rely and upon which they did act or failed to act to their damage . . . , but such information is not actionable unless expressed directly, with knowledge or notice that it will be acted upon, to one whom the author is bound by some relation of duty, arising out of

> contract or otherwise, to act with care if he acts at all . . . ." [Citations omitted.]

White v. Guarente, supra, 43 N.Y.2d at 362-63. See also *International Products, supra,* 244 N.Y. at 388.

Appellants presented ample evidence of the first three elements of negligent misrepresentation. Murfitt's and Arnold's testimony entitled a jury to conclude that Silverman misrepresented the negotiability of the Equity National stock while expecting appellants to rely on his representations, on one or both of two occasions—during the alleged telephone conversation between Murfitt and Silverman on March 2, 1972, and at the closing itself. In addition, a jury might have found that reliance on these alleged misrepresentations was the proximate cause of appellants' loss. The inquiry, then, must be whether the negligent misrepresentation claim fails either because Silverman's alleged misrepresentations were not "expressed directly, with knowledge or notice that [they would] be acted upon," or because Bankers Trust was not "bound by some relationship of duty, arising out of contract or otherwise."

In the classic genre of cases limiting the scope of accountant liability, it is the first of these requirements which has been thought to pose the most formidable barrier to the plaintiff. See *Ultramares, supra; White v. Guarente, supra.* Here, by contrast, this requirement was amply met by the direct dealings between Silverman and appellants' representatives, coupled with Murfitt's testimony that Silverman was informed of appellants' identities and intentions. These appellants seek "redress, not as a mere member of the public, but as one of a settled and particularized class

among the members of which the [information] would be circulated for [a] specific purpose," *White v. Guarente, supra,* 43 N.Y.2d at 363. In short, granting appellants a negligent misrepresentation remedy in no way threatens to open the floodgates of liability as feared by Judge Cardozo in *Ultramares, supra.*

The remaining question is whether appellants had the requisite relationship to Bankers Trust. No New York decisions are precisely in point; in fact, New York's case law in this entire area is notably limited, perhaps because it has developed in the shadow of *Ultramares.* The general rule that applies in the majority of American jurisdictions at the present time is that the critical factor in the relationship between the parties is their reasonable expectations, not their formal legal relationship. This is reflected in the Restatement (2d) of Torts §552 (1977), which states: "One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information." See *Cooper v. Jevne,* 56 Cal. App. 3d 860, 128 Cal. Rptr. 724 (1976); *Security National Bank v. Lish,* 311 A.2d 833 (D.C. App. 1973); *Williams v. Polgar,* 43 Mich. App. 95, 204 N.W.2d 57 (1972); *Moore v. Kluthe & Lane Insurance Agency, Inc.,* 234 N.W.2d 260 (S.D. 1975); *Obde v. Schlemeyer,* 353 P.2d 672 (Wash. 1960).

Whether New York would apply this general rule appears to us to be an open question. It is true that a literal reading of the language in *Ultramares* suggests

that the New York courts would apply the more restrictive requirement of formal legal relationship to claims based on negligent misrepresentation. However, it must be remembered that the reference to legal relationship in *Ultramares* was essentially dictum, since the case was decided on the privity issue. A prior case decided by the New York Court of Appeals, also written by Judge Cardozo suggests a rule that is more in consonance with the current rule in other jurisdictions. This case, *Glanzer v. Shepard, supra,* involved buyers of beans who overpaid a seller in reliance on a negligently inflated certificate of weight provided by a public weigher engaged by the seller. Judge Cardozo established the weigher's liability to the buyers thus injured by looking *inter alia* to the prospective use of the weigher's representations, their proximity to the "governance of conduct," and their appearance against prevailing standards of usage and fair dealing. 233 N.Y. at 239-41. This suggests a test quite similar to the one that currently appears in the *Restatement,* in that it focuses on the reasonable expectations of the buyers. *Ultramares,* decided nine years later, did not purport to overrule *Glanzer;* in fact, it carefully distinguished Glanzer on the question of privity, and did not refer to that case's discussion concerning the origin of the legal duty.

In the most recent decision of the New York Court of Appeals to consider this issue, *White v. Guarente, supra,* such conflict as there may be between *Glanzer* and *Ultramares* was not explicitly resolved. The *White* Court defined negligent misrepresentation in terms of "carelessness in imparting words upon which others were expected to rely"; however, it limited the scope of liability with the requirement that the author of the

words must be bound to the recipient by "some relation of duty, arising out of contract or otherwise, to act with care if he acts at all." 43 N.Y.2d at 362-363. While the reference to duty suggests *Ultramares,* the emphasis on reliance, and the open-ended notion that the duty can be one arising "out of contract or otherwise," suggests the *Glanzer* notion of prevailing standards and buyer expectations. See *Banker Trust Co. v. Steenburn,* 95 Misc. 2d 967, 991-92, 409 N.Y.S.2d 51, 66 (Sup. Ct. 1978). See also *Gediman v. Anheuser Busch, Inc.,* 229 F.2d 537, 543-44 (2 Cir. 1962).

Given the language of the few recent New York cases that have dealt with this issue, we predict that New York courts, when directly confronted with the issue, would hold that the *Restatement's* requirements that the seller be acting in the course of his business, that the information be supplied for the guidance of the buyer, and that the buyer justifiably relied on it, establish a sufficient relationship of duty between buyer and seller to support an action for negligent misrepresentation.

The criteria of *Glanzer* and the *Restatement* were met in this case. It was thus error to refuse to submit plaintiff's negligent misrepresentation claim to the jury.

The judgment is reversed and the cause remanded for a new trial consistent with this opinion.

Judgement of the Court of Appeals

United States Court of Appeals

FOR THE

SECOND CIRCUIT

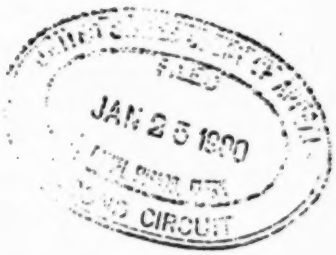
At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-fifth day of January one thousand nine hundred and eighty.

Present: HON. HENRY J. FRIENDLY

HON. JAMES L. OAKES

HON. JON O. NEWMAN

Circuit Judges,



SAMUEL MALLIS and FRANKLYN B. KAPFERMAN Plaintiffs-Appellants v. BANKERS TRUST COMPANY Defendant BANKERS TRUST COMPANY Third-Party Plaintiff v. JEROME B. KATES and JACK J. ARNOLD Third-Party Defendants JACK J. ARNOLD Third-Party Defendant-Appellee	79-7416

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is reversed and the action be and it hereby is remanded to said district court for further proceedings in accordance with the opinion of this court with costs to be taxed against the appellee.

A. DANIEL FUSARO,
Clerk

Arthur Heller

By: Arthur Heller,
Deputy Clerk

Opinion of the Supreme Court Dismissing Certiorari as Improvidently Granted

Syllabus

BANKERS TRUST CO. *v.* MALLIS ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 76-1359. Argued November 30, 1977—Decided March 28, 1978

In dismissing respondents' action against petitioner under § 10 (b) of the Securities Exchange Act of 1934, the District Court failed to set forth the judgment in a separate document as required by Fed. Rule Civ. Proc. 58. Despite the absence of a separate judgment but without objection by petitioner, the Court of Appeals assumed appellate jurisdiction under 28 U. S. C. § 1291 giving courts of appeals jurisdiction of appeals from all "final decisions" of the district courts, and reversed on the merits. *Held:*

1. Under the circumstances the parties should be deemed to have waived Rule 58's separate-judgment requirement, and hence the Court of Appeals properly assumed appellate jurisdiction under § 1291.

2. Where, however, the case's posture changed between the time of the Court of Appeals' decision and the presentation of the case to this Court, respondents' counsel having urged here that the Court of Appeals' judgment be affirmed on a theory different from that court's reasoning in reversing the District Court, the writ of certiorari is dismissed as having been improvidently granted.

Certiorari dismissed. Reported below: 568 F. 2d 824.

Jack H. Weiner argued the cause for petitioner. With him on the briefs was *Charles Leeds.*

Noel W. Hauser argued the cause and filed a brief for respondents.

John L. Warden argued the cause and filed a brief for the New York Clearing House Assn. as *amicus curiae* urging reversal.

Harvey L. Pitt argued the cause for the Securities and Exchange Commission as *amicus curiae* urging affirmance. With him on the brief were *Solicitor General McCree, Paul Gonson, Jacob H. Stillman,* and *James. E. Bowers.*

Opinion of the Supreme Court Dismissing Certiorari as Improvidently Granted

PER CURIAM.

Respondents sued petitioner Bankers Trust Co. under § 10 (b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U. S. C. § 78j (b) (1976 ed.), for allegedly fraudulent statements. The District Court for the Southern District of New York dismissed the action on the ground that the fraud alleged had not occurred "in connection with the purchase or sale" of a security, as required by § 10 (b). *Mallis* v. *Federal Deposit Ins. Corp.*, 407 F. Supp. 7 (1975). The Court of Appeals for the Second Circuit reversed, holding that respondents were "purchasers [of securities] by virtue of their acceptance of [a] pledge" of stock and that petitioner was "a seller by virtue of its release of [a] pledge." *Mallis* v. *Federal Deposit Ins. Corp.*, 568 F. 2d 824, 830 (1977). We granted certiorari to consider the correctness of these rulings of the Court of Appeals. 431 U. S. 928 (1977).

We find ourselves initially confronted, however, by a difficult question of federal appellate jurisdiction. As the Court of Appeals noted in its opinion, a search of the District Court record fails to uncover "any document that looks like a judgment." 568 F. 2d, at 827 n. 4. Because both the parties and the District Court "proceeded on the assumption that there was an adjudication of dismissal," *ibid.*,[1] the Court of Appeals felt free to consider the merits of the appeal. The Court of Appeals action, however, conflicts with the decisions of other Courts of Appeals concluding that a judgment set forth on a "separate document" is a prerequisite to appel-

[1] Respondents appealed from a combined opinion and order of the District Court dated September 30, 1975. In the relatively lengthy opinon, the District Court granted petitioner's motion to dismiss the claim for failure to state a federal claim upon which relief could be granted and then concluded: "Complaint dismissed in its entirety. So ORDERED." On the same day, an entry was made on the District Court docket reading, "Complaint dismissed in its entirety. So Ordered. Pollack, J. (mn)."

late jurisdiction.[2] We conclude that the Court of Appeals for the Second Circuit was correct in deciding that it had jurisdiction in this case despite the absence of a separate judgment.

Appellate jurisdiction was invoked under 28 U. S. C. § 1291, which provides that the "courts of appeals shall have jurisdiction of appeals from all final decisions of the district courts of the United States." The issue posed is whether a decision of a district court can be a "final decision" for purposes of § 1291 if not set forth on a document separate from the opinion. The issue arises because of Fed. Rule Civ. Proc. 58, which reads in part:

> "Every judgment shall be set forth on a separate document. A judgment is effective only when so set forth and when entered as provided in Rule 79 (a)." [3]

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[2] See, *e. g.*, *Lyons* v. *Daveren*, 402 F. 2d 890 (CA1 1968); *Sassoon* v. *United States*, 549 F. 2d 983 (CA5 1977); *Richland Trust Co.* v. *Fed. Ins. Co.*, 480 F. 2d 1212 (CA6 1973); *Home Fed. Sav. & Loan* v. *Republic Ins. Co.*, 405 F. 2d 18 (CA7 1968); *Baity* v. *Ciccone*, 507 F. 2d 717 (CA8 1974); *Baker* v. *Southern Pac. Transp.*, 542 F. 2d 1123 (CA9 1976). But see *W. G. Cosby Transfer & Storage Corp.* v. *Froehlke*, 480 F. 2d 498, 501 n. 4 (CA4 1973).

[3] Rule 58 reads in its entirety:

"Subject to the provisions of Rule 54 (b): (1) upon a general verdict of a jury, or upon a decision by the court that a party shall recover only a sum certain or costs or that all relief shall be denied, the clerk, unless the court otherwise orders, shall forthwith prepare, sign, and enter the judgment without awaiting any direction by the court; (2) upon a decision by the court granting other relief, or upon a special verdict or a general verdict accompanied by answers to interrogatories, the court shall promptly approve the form of the judgment, and the clerk shall thereupon enter it. Every judgment shall be set forth on a separate document. A judgment is effective only when so set forth and when entered as provided in Rule 79 (a). Entry of the judgment shall not be delayed for the taxing of costs. Attorneys shall not submit forms of judgment except upon direction of the court, and these directions shall not be given as a matter of course."

We assume, without deciding, that the requirements for an effective judgment set forth in the Federal Rules of Civil Procedure must generally be satisfied before § 1291 jurisdiction may be invoked.[4] We nonetheless conclude that it could not have been intended that the separate-document requirement of Rule 58 be such a categorical imperative that the parties are not free to waive it.

The sole purpose of the separate-document requirement, which was added to Rule 58 in 1963, was to clarify when the time for appeal under 28 U. S. C. § 2107 begins to run.[5] According to the Advisory Committee that drafted the 1963 amendment:

> "Hitherto some difficulty has arisen, chiefly where the court has written an opinion or memorandum containing some apparently directive or dispositive words, e. g., 'the plaintiff's motion [for summary judgment] is granted,' see United States v. F. & M. Schaefer Brewing Co., 356 U. S. 227, 229 . . . (1958). Clerks on occasion have viewed these opinions or memoranda as being in themselves a

[4] A "judgment" for purposes of the Federal Rules of Civil Procedure would appear to be equivalent to a "final decision" as that term is used in 28 U. S. C. § 1291. Federal Rule Civ. Proc. 54 (a), for example, provides that "'[j]udgment' as used in these rules includes a decree and any order from which an appeal lies." See also *Ex parte Tiffany*, 252 U. S. 32, 36 (1920); 6A J. Moore, Federal Practice ¶ 58.02, pp. 51–52 (1972). Because Rule 58 provides that a "judgment is effective only . . . when entered as provided in Rule 79 (a)," it is arguable that a decision must be entered on the civil docket before it may constitute a "final decision" for purposes of § 1291. Unlike the separate-document requirement, however, the keeping of a civil docket pursuant to Rule 79 fulfills a public recordkeeping function over and above the giving of notice to the losing party that a final decision has been entered against it. A judgment of dismissal was entered in this case below. See n. 1, *supra*.

[5] Section 2107 provides that "[e]xcept as otherwise provided in this section, no appeal shall bring any judgment, order or decree in an action, suit or proceeding of a civil nature before a court of appeals for review unless notice of appeal is filed, within thirty days after the entry of such judgment, order or decree." See also Fed. Rule App. Proc. 4 (a).

381 Per Curiam

> sufficient basis for entering judgment in the civil docket as provided by Rule 79 (a). However, where the opinion or memorandum has not contained all the elements of a judgment, or where the judge has later signed a formal judgment, it has become a matter of doubt whether the purported entry of a judgment was effective, starting the time running for post verdict motions and for the purpose of appeal. . . .
>
> "The amended rule eliminates these uncertainties by requiring that there be a judgment set out on a separate document—distinct from any opinion or memorandum—which provides the basis for the entry of judgment." 28 U. S. C. App., p. 7824.

The separate-document requirement was thus intended to avoid the inequities that were inherent when a party appealed from a document or docket entry that appeared to be a final judgment of the district court only to have the appellate court announce later that an earlier document or entry had been the judgment and dismiss the appeal as untimely. The 1963 amendment to Rule 58 made clear that a party need not file a notice of appeal until a separate judgment has been filed and entered. See *United States* v. *Indrelunas*, 411 U. S. 216, 220–222 (1973). Certainty as to timeliness, however, is not advanced by holding that appellate jurisdiction does not exist absent a separate judgment. If, by error, a separate judgment is not filed before a party appeals, nothing but delay would flow from requiring the court of appeals to dismiss the appeal. Upon dismissal, the district court would simply file and enter the separate judgment, from which a timely appeal would then be taken. Wheels would spin for no practical purpose.[6]

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[6] Nor would strict compliance with the separate-judgment requirement aid in the court of appeals' determination of whether the decision of the District Court was "final" for purposes of § 1291. Even if a separate judgment is filed, the courts of appeals must still determine whether the

In *United States* v. *Indrelunas*, we recognized that the separate-document rule must be "mechanically applied" in determining whether an appeal is timely. *Id.*, at 221–222.[7] Technical application of the separate-judgment requirement is necessary in that context to avoid the uncertainties that once plagued the determination of when an appeal must be brought. Cf. *United States* v. *F. & M. Schaefer Brewing Co.*, 356 U. S. 227 (1958). The need for certainty as to the timeliness of an appeal, however, should not prevent the parties from waiving the separate-judgment requirement where one has accidentally not been entered. As Professor Moore notes, if the only obstacle to appellate review is the failure of the District Court to set forth its judgment on a separate document, "there would appear to be no point in obliging the appellant to undergo the formality of obtaining a formal judgment." 9 J. Moore, Federal Practice ¶ 110.08 [2], p. 120 n. 7 (1970). "[I]t must be remembered that the rule is designed to simplify and make certain the matter of appealability. It is not designed as a trap for the inexperienced. . . . The rule should be interpreted to prevent loss of the right of appeal, not to facilitate loss." *Id.*, at 119–120.

The Federal Rules of Civil Procedure are to be "construed

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district court intended the judgment to represent the final decision in the case. Cf. *United States* v. *Hark*, 320 U. S. 531 (1944).

[7] While our decision in *Indrelunas* is consistent with the result we reach today, the beginning paragraph of *Indrelunas* could be read as holding that a separate judgment must be filed in compliance with Rule 58 before a decision is "final" for purposes of § 1291. In *Indrelunas*, we noted that since both parties conceded "that the jurisdiction of the Court of Appeals was based on the provisions of 28 U. S. C. § 1291, making final decisions of the district courts appealable, the correctness of the Court of Appeals' decision depends on whether the District Court's judgment of February 25, 1971, was a final decision. That question, in turn, depends on whether actions taken in the District Court previous to the February date amounted to the 'entry of judgment' as that term is used in Fed. Rule Civ. Proc. 58." 411 U. S., at 216. To the extent the above passage is inconsistent with our decision today, we disavow it.

to secure the just, speedy, and inexpensive determination of every action." In *Foman* v. *Davis*, 371 U. S. 178 (1962), this Court was asked to apply Rule 73 which, as then written, provided that an appeal was to be taken "by filing with the District Court a notice of appeal," which notice "shall designate the judgment or part thereof appealed from." Under Rule 73 it was clear that the filing of a notice of appeal was "jurisdictional," and the contents of the notice of appeal were prescribed in the Rule. This Court nonetheless held in *Foman* that a notice of appeal from a denial of motions to vacate a judgment and to amend the complaint was, in view of an earlier and premature notice of appeal, a notice of appeal from the original judgment.

> "The defect in the second notice of appeal did not mislead or prejudice the respondent. With both notices of appeal before it (even granting the asserted ineffectiveness of the first) the Court of Appeals should have treated the appeal from the denial of the motions as an effective, although inept, attempt to appeal from the judgment sought to be vacated." 371 U. S., at 181.

The same principles of common-sense interpretation that led the Court in *Foman* to conclude that the technical requirements for a notice of appeal were not mandatory where the notice "did not mislead or prejudice" the appellee demonstrate that parties to an appeal may waive the separate-judgment requirement of Rule 58. "It is too late in the day and entirely contrary to the spirit of the Federal Rules of Civil Procedure for decisions on the merits to be avoided on the basis of such mere technicalities." 371 U. S., at 181.

Here, the District Court clearly evidenced its intent that the opinion and order from which an appeal was taken would represent the final decision in the case. A judgment of dismissal was recorded in the clerk's docket. And petitioner did not object to the taking of the appeal in the absence of a

separate judgment. Under these circumstances, the parties should be deemed to have waived the separate-judgment requirement of Rule 58 and the Court of Appeals properly assumed appellate jurisdiction under § 1291.

Although we conclude that the Court of Appeals did have appellate jurisdiction to pass on the merits of this case, we do not reach them. At oral argument, counsel for respondents took the position that "the mere release of a pledge is [not] a sale." Tr. of Oral Arg. 32. Counsel urged that the judgment of the Court of Appeals be affirmed on a theory which differed from the reasoning of the Court of Appeals in reversing the District Court. Because of the change in the posture of the case between the time of the decision of the Court of Appeals and its presentation to us for decision, we dismiss the writ of certiorari as having been improvidently granted.

Dismissed.

MR. JUSTICE BLACKMUN took no part in the consideration or decision of this case.

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Opinion of the Court of Appeals (Mallis I)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 26—September Term, 1976.

(Argued October 18, 1976 Decided January 3, 1977.)

Docket No. 76-7166

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs-Appellants,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and BANKERS TRUST COMPANY,

Defendants-Appellees.

Before:

SMITH, OAKES and TIMBERS,

Circuit Judges.

Appeal from judgment entered in the Southern District of New York, Milton Pollack, *District Judge,* 407 F.Supp. 7, dismissing complaint for failure to state claims upon which relief can be granted and denying leave to amend complaint in action to recover damages and for other relief resulting from alleged violations of Regulation U of the Board of Governors of the Federal Reserve System and of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Affirmed as to dismissal of Regulation U claim; as to dismissal of Securities Exchange Act claim, reversed and remanded with directions.

NOEL W. HAUSER, New York, N.Y. (Hauser & Rosenbaum, New York, N.Y., on the brief), *for Plaintiffs-Appellants.*

JACK H. WEINER, New York, N.Y. (Charles Leeds, New York, N.Y., on the brief), *for Defendant-Appellee Bankers Trust Company.*

PHILIP K. HOWARD, New York, N.Y. (John L. Warden, and Sullivan & Cromwell, New York, N.Y., on the brief), *for Defendant-Appellee European-American Bank & Trust Company.*

ROBERT S. ANDERSON, New York, N.Y. (Hughes Hubbard & Reed, New York, N.Y., on the brief), *for Defendant-Appellee Franklin National Bank.*

TIMBERS, *Circuit Judge:*

This appeal is from a judgment entered in the Southern District of New York, Milton Pollack, *District Judge,* 407 F.Supp. 7, dismissing the complaint for failure to state claims upon which relief can be granted and denying leave to amend the complaint in an action to recover damages and for other relief resulting from alleged violations of Regulation U of the Board of Governors of the Federal Reserve System, 12 C.F.R. §221 (1976), and alleged violations of the antifraud provisions of the federal securities laws, including Section 10(b) of the Securities Exchange

Act of 1934, 15 U.S.C. §78j(b)(1970), and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5 (1976).

The essential questions which we find presented and our rulings thereon are as follows:

(1) Whether a bank loan to appellants by Franklin National Bank was subject to Regulation U.

We hold that it was not.

(2) Whether appellants as pledgees of stock certificates of Equity National Industries, Inc. have standing to sue under Section 10(b) and Rule 10b-5.

We hold that they do.

For the reasons below, we affirm the dismissal of the Regulation U claim against European-American Bank & Trust Company and Franklin National Bank; but as to the dismissal of the Securities Exchange Act claim against the Bankers Trust Company, we reverse and remand with directions.

I. Facts

Appellants Mallis and Kupferman are dentists.[1] Between March 1 and March 3, 1972 Jack J. Arnold, an attorney, persuaded them to make a short term loan of $156,000 to himself and his client, John B. Fowler, to finance the purchase of 40,034 shares of stock in Equity National Industries, Inc. (Equity National). The consideration to appellants was to be $50,000. In addition, appellants were to receive possession of the Equity National stock certificates as collateral. To fulfill their part of the agreement, appellant immediately obtained a loan of $156,000 from appellee Franklin National Bank (Franklin

1 We assume familiarity with the comprehensive statement of facts in the district court opinion. 407 F.Supp. at 9-10.

National). The parties dispute whether this loan was to have been secured in turn by the Equity National certificates. This issue was not resolved by the district court.

Title to the Equity National shares desired by Arnold and Fowler was in Jerome and Judith Kates. But the certificates were in the possession of the Bankers Trust Company (Bankers Trust), to which the Kateses had pledged the shares as collateral for a loan. The Kateses still owed $45,000 on this loan on March 3, 1972.

The shares, which the Kateses had acquired pursuant to a merger between a corporation under their control and Equity National, were subject to an escrow agreement which required the return of the certificates to Equity National for cancellation or reissue depending on whether the acquired corporation met specified earnings conditions. Each certificate bore a legend which declared it to be subject to the escrow agreement and restricted transfer except in accordance with the terms of the agreement. Although other Equity National shares of the same series were registered under the Securities Act of 1933 and listed on the American Stock Exchange (Amex), the shares issued to the Kateses were not.

By a letter to Bankers Trust, Equity National had recalled the Kateses' shares for cancellation in March 1971. As a result the shares were worthless when the transactions here at issue occurred in March 1972.

A closing was held on March 3, 1972. Arnold and Fowler, the Kateses, and representatives of Franklin National and Bankers Trust were in attendance, but not appellants. Franklin National's representative delivered three checks totalling $156,000 to the Kateses. The Kateses endorsed one of the checks in amount of $45,000 to Bankers Trust. Bankers Trust then released the Equity National certificates. The Kateses transferred the certificates to Arnold

and Fowler who subsequently delivered them to appellants in accordance with the loan agreement.

The instant action arises from the failure of Arnold and Fowler to repay their loan from appellants. In the district court appellants sought to assert two claims. First, they sought relief against Franklin National, now insolvent, and the European-American Bank & Trust Company (European-American), which purchased appellants' note along with Franklin National's other assets.[2] They sought recission of their loan from Franklin National on the ground that the loan was made for the purpose of acquiring margin stock in an amount in excess of the maximum loan value of the stock in violation of Regulation U.[3] Second, they alleged that Bankers Trust violated the Securities Act of 1933 in disposing of the unregistered Equity National shares in the course of terminating their pledge agreement with the Kateses. During the course of proceedings in the district court appellants departed from this theory, which apparently looked to Section 12(1) of the 1933 Act, 15 U.S.C. §771(1)(1970), and requested leave to amend their complaint to state a cause of action under Section 10(b) of the 1934 Act and Rule 10b-5 thereunder. The theory underlying their claim against Bankers Trust

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2 The successors in interest to insolvent Franklin National are European-National and the Federal Deposit Insurance Corporation (FDIC).

As the receiver of Franklin National, FDIC was named in the complaint as a defendant with respect to appellants' Regulation U claim. Appellants since have stipulated to dismissal of their action against FDIC. Although Franklin National remains as a party, appellants no longer seek a money judgment against it.

3 The complaint also alleged a pendant claim against Franklin National based on common law fraud. After dismissing appellants' federal claim against Franklin National, the district court dismissed the pendant claim for lack of subject matter jurisdiction and denied leave to amend it to assert a cause of action against Franklin National under the Securities Exchange Act. Appellants since have stipulated to the dismissal of both of these claims.

is that it knowingly misrepresented that the certificates no longer were subject to the escrow agreement.

European-American, Franklin National and Bankers Trust moved to dismiss the complaint for failure to state claims upon which relief can be granted. The court granted the motions and dismissed the complaint in its entirety. In granting the motions of European-American and Franklin National to dismiss the Regulation U claim, the court held that Franklin National's loan was not made for the purpose of carrying or purchasing margin stock within the meaning of Regulation U. In granting the motion of Bankers Trust to dismiss, the court held that appellees, as pledgees, were not "purchasers" of securities and therefore could not state a claim under the 1933 Act. For the same reason the court denied leave to appellants to amend their complaint to allege a claim under Section 10(b) of the 1934 Act and Rule 10b-5.

From the judgment dismissing the complaint and the order denying leave to amend, this appeal has been taken.[4]

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4 Appellants' notice of appeal filed March 24, 1976 is "from the Order and Judgment of the HON. MILTON POLLACK".

Judge Pollack's opinion ordering dismissal of the complaint was filed September 30, 1975. On December 5, 1975, on motion of appellants' counsel, the judge filed a Rule 54(b) certificate directing the entry of a final judgment with respect to all defendants except FDIC so as to permit the instant appeal. We note that Judge Pollack's Rule 54(b) certificate complies with the approved practice in this Circuit that the required determination that there is no just reason for delay "ought not to be made as a matter of rote". *Arlinghaus* v. *Ritenour*, —— F.2d ——, —— (2 Cir. 1976), slip op. 239, 243 (October 26, 1976); *Gummer* v. *Shearson, Hammill & Co., Inc.*, 516 F.2d 283, 286 (2 Cir. 1974). Judge Pollack's finding that "[t]here is no just reason for leaving the claim against FDIC hanging in limbo and creating piecemeal appellate litigation" produced the additional therapeutic result of appellants' dismissal of their action against FDIC. See note 2, *supra*.

However, since "[e]very good case requires a mystery document", *Westchester Fire Insurance Company* v. *Tantalo*, 273 F.Supp. 7, 12 n. 5 (D. Conn. 1967), it appears that the mystery document here is the judgment itself. Our search of the voluminous appendix and original district court record has failed to uncover any document that looks like a judg-

II. Regulation U Claim

The district court dismissed appellants' Regulation U claim for recission against European-American and Franklin National on the ground that Regulation U does not apply to the loan in question. 407 F.Supp at 10-11. We agree.

Regulation U prohibits banks from extending credit,

> "directly or indirectly . . . for the purpose of purchasing or carrying any margin stock in an amount exceeding the maximum loan value of the collateral. . . ." 12 C.F.R. § 221.1(a) (1976).[5]

The only definition of "margin stock" set forth in Regulation U which even approaches applicability to the instant shares is that of "a stock registered on a national securities exchange". 12 C.F.R. §221.3(v)(1).[6] Although other shares of the same series were listed on the Amex, the particular Equity National shares here in question were not listed on any national securities exchange. They therefore were not

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ment. Since the parties and the district court have proceeded on the assumption that there was an adjudication of dismissal, we decline to stand on the technicality of the missing mystery document in this case.

5 "Maximum loan values" are set forth in 12 C.F.R. §221.4 (1976).

6 12 C.F.R. §221.3(v) (1976) defines "margin stock" as:

> ". . . (1) a stock registered on a national securities exchange, (2) an OTC margin stock, (3) a debt security (i) convertible with or without consideration, presently or in the future, into a margin stock, or (ii) carrying any warrant or right to subscribe to or purchase, presently or in the future, a margin stock; (4) any such warrant or right, (5) any security issued by an investment company licensed under the Small Business Investment Company Act of 1958 . . . registered pursuant to section 8 of the Investment Company Act of 1940 . . . unless at least 95 percent of the assets of such company are continuously invested in exempted securities."

"margin stock" so as to trigger the application of Regulation U to the Bankers Trust loan.[7]

Moreover, appellants were neither "purchasing" nor "carrying" stock within the meaning of Regulation U. 12 C.F.R. §221.1(a), *supra*. The Regulation specifically brings within its ambit credit extended to a bank customer engaged "principally, or as one of the customer's important activities, in the business of extending credit for the purpose of purchasing or carrying margin stocks. . . ." 12 C.F.R. §221.3(g)(1976). Under the circumstances of this case, we construe this provision to state conditions which must be met before the Regulation will apply to an intermediate borrower who reloans the funds to enable another to purchase stock. Appellants, the intermediate borrowers here, and an independent interest in the transaction and bore an independent risk. We therefore need not decide whether we would construe §221.3(g) otherwise if the intermediate loan were a sham entered into to circumvent the Regulation's application. Since borrowing for the purpose of relending to enable others to purchase or carry margin stock was not one of appellants' "important activities", we hold that Regulation U does not apply to the Franklin National loan.

Funtrhermore, European-American would be insulated from appellants' rescission claim even if Regulation U were applicable here. Section 29(c)(2) of the 1934 Act, 15 U.S.C. §78cc(c)(2) (1970), bars construction of the Act or any regulation promulgated under it to afford a defense against "the collection of any debt . . . by any person who shall have acquired [it] in good faith for value and without actual knowledge of the violation" of the Act or regulation. Regulation U was promulgated pursuant to Sec-

7 We agree with the district court's holding that the fact that other shares of the same series were listed on the Amex does not alter the the result. 407 F.Supp. at 10-11.

tion 7 of the 1934 Act, 15 U.S.C. §78g (1970). European-American's payment of value for appellants' obligation, its good faith, and its lack of actual knowledge of any underlying irregularity are not disputed. Accordingly, even if Regulation U were otherwise applicable, we hold that Section 29(c)(2) would bar appellants from asserting their recission claim against Eurpoean-American.

III. Securities Exchange Act Claim

This brings us to what we regard as the chief question in the case: whether appellants have standing to sue under Section 10(b) of the 1934 Act and Rule 10b-5. Specifically, the issue is whether under the definition of "sale" in Section 3(14) of the 1934 Act, 15 U.S.C. §78c(14) (1970), a pledge fulfills the familiar requirement that the fraud occur "in connection with the purchase or sale" of a security.

In resolving the standing question against appellants, the district court relied on *McClure* v. *First National Bank of Lubbock*, 497 F.2d 490 (5 Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). There the court acknowledged that a pledgor might be liable for fraud under Section 10(b) after his default and a consequent sale of the securities by the pledgee, but held that the pledge itself did not constitute a "sale". At the time of the decision below in the instant case, the district court did not have the benefit of our subsequent decision which rejected the rationale of *McClure* in a case arising under Section 17(a) of the 1933 Act. *United States* v. *Gentile*, 530 F.2d 461 (2 Cir.), *cert. denied*, —— U.S. —— (1976). We hold that *Gentile* and our earlier decision in *SEC* v. *Guild Films Co.*, 279 F.2d 485 (2 Cir.), *cert. denied*, 364 U.S. 819 (1960), control here and require that appellants be granted standing.

In *Guild Films* we held a pledge of stock to be a "sale" within the meaning of Section 2(3) of the 1933 Act, 15 U.S.C. §77b(3) (1970),[8] in the context of determining that the pledgees there involved were "person[s] who [have] purchased from an issuer" within the meaning of the definition of "underwriter" in Section 2(11) of the 1933 Act, 15 U.S.C. §77b(11) (1970). *SEC* v. *Guild Films Co., supra,* 279 F.2d at 489.[9] *Gentile* reaffirmed and expanded this holding. The defendant there was charged with a conspiracy to pledge fraudulently issued securities in violation of Section 17(a) of the 1933 Act, 15 U.S.C. §77q(a) (1970). We again held a pledge to constitute a "sale" within Section 2(3), this time to satisfy the requirements of Section 17(a) that the fraud occur "in the offer or sale of any securities". *United States* v. *Gentile, supra,* 530 F.2d at 466-67. We held:

> "In effect, the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as the indisputable basis for statutory regulation of securities transactions. We therefore find no reason to treat the equivalent risks differently under the statute." *Id.* at 467.[10]

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8 Section 2(3) defines a "sale" to include "every contract of sale or disposition of a security or interest in a security for value."

9 We reasoned that the term "purchaser", "although not defined in the Act, should be interpreted in a manner complementary to 'sale'." *SEC* v. *Guild Films Co., supra,* 279 F.2d at 489.

10 In rejecting the distinction drawn in *McClure* between the pledged shares while in the pledgee's possession and the same shares after a sale due to the pledgor's default, we stated:

> "We see no reason to make the character of the initial pledge dependent upon subsequent events." *United States* v. *Gentile, supra,* 530 F.2d at 467 n. 6.

The fact that *Gentile* was a criminal case in which civil standing was not an issue does not diminish its persuasion as a precedent with respect to the Section 10(b) claim before us. The existence of a "sale" is as essential to a criminal prosecution for violation of Section 17(a) as it is to a civil action under that section. We find no basis on the face of either the 1933 Act or the 1934 Act for denominating a pledge as a "sale" for criminal but not for civil purposes.

Nor would the standing policy enunciated by the Supreme Court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), support such a conclusion. We recognize that the Court there expressed concern about vexatious suits by a potentially limitless class of plaintiffs. We further recognize that the granting of standing to pledgees creates potential plaintiffs where none might have existed. But a closer look at *Blue Chip* demonstrates that the specific concerns there expressed by the Court have no bearing on the question before us of granting standing to pledgees. The Court in *Blue Chip* had before it a plaintiff who claimed that the defendant's misrepresentations caused it to refrain from purchasing securities. The Court observed that the rule of *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2 Cir.), *cert. denied*, 343 U.S. 956 (1952), requiring a purchase or sale, had the virtue of excluding a class of plaintiffs who had not dealt in the security at all and whose cases as a result would stand or fall on oral testimony. Requiring that the plaintiff have "dealt in" the security would assure that each case stand upon at least one "objectively demonstrable fact." *Id.* at 746-47. A pledge which occurs pursuant to a loan contract is just as concrete a transaction as is a normal transfer of title.[11]

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11 Bankers Trust seeks to distinguish *Gentile* and *Guild Films* from the instant case on the further ground that neither of the pledges involved

We believe that the rationale underlying our holding in *Gentile* with respect to Section 2(3) and 17(a) of the 1933 Act is persuasive authority for holding that a pledge constitutes a "contract to sell or otherwise dispose of" a security within the meaning of Section 3(14) of the 1934 Act. Accordingly, on the facts of this case, we hold that both a "sale" and a "purchase" may be cognizable under Section 10(b) of the 1934 Act. Appellants were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge.

We therefore reverse the dismissal of appellants' Securities Exchange Act claim and remand the case to the district court with directions to grant leave to appellants to amend their complaint in accordance with this opinion. See *Rogers* v. *White Metal Rolling & Stamping Corp.*, 249 F.2d 262 (2 Cir. 1957), *cert. denied*, 356 U.S. 936 (1958).[12]

Affirmed as to the dismissal of the Regulation U claim against European-Amercian and Franklin National; but as to the dismissal of the Securities Exchange Act claim against Bankers Trust, reversed and remanded with directions to grant leave to appellants to amend their complaint in accordance with this opinion.[13]

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in those cases were bona fide. We fail to see what connection the pledgor's state of mind has with the question whether the pledgee has standing to sue. Such a distinction would be at odds with our rationale in *Gentile*.

12 Bankers Trust also contends that the dismissal of an earlier common law fraud action brought against it and others by appellants in the New York state courts should have a collateral estoppel effect so as to bar appellants' claim under Section 10(b). This defense is a matter for trial which we do not reach now. But see *Herendeen* v. *Champion International Corp.*, 525 F.2d. 130 (2 Cir. 1975).

13 Having given due consideration to the motion by counsel for European-American for an award of attorneys' fees and double costs, we deny it.

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Decision of the District Court.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 Civ. 909 (MP)

MEMORANDUM

#43153

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and THE BANKERS TRUST COMPANY,

Defendants.

APPEARANCES:

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MILTON POLLACK, District Judge.

Federal Deposit Insurance Corporation (FDIC hereafter) and European American Bank (EA) are successors in interest to an insolvent, Franklin National Bank (FNB).

Plaintiffs, two dentists, borrowed $156,000 from FNB on March 3, 1972, and now claim that the loan (reduced substantially by repayments on account) violated Regulation U (Federal Reserve Regulations 12 CFR Section 221.1 et seq.) prohibiting loans secured by margin stock in an amount in excess of the prescribed maximum loan value of the stock. Plaintiffs contend in their first claim for relief that the loan was made for the purposes of carrying or acquiring margin stock and is therefore void and that it should be declared that they are not liable thereon.

Since the loan was neither directly nor indirectly made for the purpose of carrying or purchasing "margin stock" or being secured thereby nor were the arrangements with plaintiffs interposed as a subterfuge for avoidance of Regulation U by FNB, the first claim fails to state a claim on which federal relief may be granted.

Plaintiffs, Mallis and Kupferman, arranged the loan from FNB based solely on their signatures to a loan agreement. Their purpose was to take advantage of a busi-

ness opportunity which they hoped would yield them a $50,000 profit. The opportunity involved the loan by them of money to one Fowler and his attorney Arnold on the obligation to repay the same on certain conditions with a $50,000 bonus or profit for the accommodation. Fowler had made a deposit toward the purchase of 40,000 shares of Equity National Industries, Inc., and needed more funds in order to complete the purchase. The shares were held by Bankers Trust Company, a defendant herein, as collateral for a loan to the shares' owners, Jerome and Judith Kates, who were the sellers in the transaction with Fowler.

The shares were unregistered, but Arnold is alleged to have represented to Mallis that they would become marketable in the near future because of a new rule promulgated by the Securities Exchange Commission. The shares if marketable would have, according to plaintiffs, been worth at least $400,000.

In actuality, the shares were subject to a restriction that ultimately made them worthless. They had been issued to the Kates pursuant to the agreement by which a company called Take-Two, Inc. was merged into a subsidiary of Equity. The two certificates for the shares bore legends indicating that the shares had not been registered under the Securities Act and could not be transferred except in accordance with an escrow agreement to which they were subject. Under the escrow agreement, depending on whether specified earnings conditions for the prior business of Take-Two were met for specified years, the shares would be returned to Equity to be either cancelled or reissued without the restrictive legend referring to the escrow agreement.

By letter of March 1, 1971, Equity wrote to Bankers Trust, which held the shares as collateral on an August 1970 loan to the Kates, indicating that the earnings requirement had not been met for 1970 and requesting that the Equity shares issued to the Kates be delivered to

Equity in accordance with the escrow agreement. Bankers Trust declined to do so. Equity brought suit in New York to obtain a cancellation of the shares but the suit did not proceed to a judicial determination. Equity ultimately brought suit in Delaware state court in May 1974 to obtain or to void the certificates of stock, naming the plaintiffs, the Kates, and FNB as defendants, but not Bankers Trust. This suit also did not go to judgment. Plaintiffs allege that the shares are now worthless, and indeed were worthless at the time of the Mallis-Arnold-Kates agreement culminating in their sale. At the closing of the sale, the funds transferred to Kates as consideration for the stock were turned over to Bankers Trust in payment of the outstanding indebtedness of the Kates to Bankers Trust. Bankers Trust then released the stock. Plaintiffs took the shares as collateral for their loan to Arnold and Fowler and now hold them after default by those borrowers.

Plaintiffs, as noted *supra,* seek to cancel their own indebtedness to FNB and its successors by alleging that the loan to them was in violation of Regulation U of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 221.1 *et seq.*, as having been secured by stock for the purpose of purchasing or carrying "margin stock" in an amount in excess of the prescribed maximum loan value of the collateral.

Plaintiffs' allegations on this point fall short of adequacy in at least two ways, even assuming *arguendo* that they have sufficiently alleged that the loans were secured by stock. *Cf. Freeman* v. *Marine Midland Bank-New York,* 494 F.2d 1334 (2d Cir. 1974). The shares in question here were not "margin stock" within the meaning of Regulation U, and there was no loan for the purpose of purchasing stock within the meaning of that regulation.

The only definitional category of margin stock which arguably applies to the certificates of Equity common stock

involved herein is that of stock "registered on a national securities exchange". It appears that listed shares of Equity common stock were in fact registered and traded on an exchange at the time of the transaction herein. However those shares here involved were neither registered nor listed on a national securities exchange.

EA and FDIC have introduced the listing application submitted to the American Stock Exchange by Equity for the listing of a number of categories of common stock including "175,000 additional shares of its common stock, *upon official notice of issuance,* which represent the maximum number of shares which the Company may be obligated to issue to the former shareholders of Take-Two, Inc. . . . if the earnings of the business formerly conducted by such company reach certain specified levels." (emphasis added) (Exhibit A to Howard affidavit, May 16, 1975).

In order for such shares to have been actually listed, Equity would have had to formally notify the Exchange that the conditions had been met, a "registration authorization" indicating the number of shares would have had to be prepared by the Exchange, and a listing fee would have had to be paid by Equity. A review of the American Stock Exchange file indicated that none of these steps had ever been taken, and that the shares were never listed, which is hardly surprising given Equity's efforts to have the shares returned to it. (*See* Howard affidavit, *supra,* ¶¶ 3 and 4).

Contrary to plaintiffs' assertions, shares of stock are not "registered" on a securities exchange within the meaning of Regulation U when they are not themselves listed merely because other shares of their class are listed. *See* Published Interpretations of the Board of Governors of the Federal Reserve System, ¶ 6440 (1971) (Regulation U not applicable to loan to purchase newly issued stock during initial over the counter trading period prior to the stock "becoming registered (listed) on a national securities

exchange"). The opinion letter of an attorney for the Board of Governors submitted to this Court by the plaintiffs is not dispositive here since the question the attorney was answering is not on point with the issue in contention. Since the Equity shares purchased from the Kates were not registered on a national securities exchange and fit into no other category set out in Regulation U, they were not "margin stock" within that regulation's meaning.

Regulation U bars a grant of credit directly or indirectly secured by any stock for the *purchase* or carrying of margin stock. EA and FDIC argue that the only situation in which Regulation U applies to loans made to a borrower who in turn relends the funds to a third person for the purchase of stock is if the initial borrower is engaged principally or as one of his important activities in the business of extending credit for the purpose of purchasing margin stock. *See* 12 C.F.R. § 221.3(q). They argue that if Regulation U applied to every loan of the type in this case, 12 C.F.R. § 221.3(q) would be superfluous.

It may well be that Regulation U would nevertheless be applicable if the initial borrower were simply interposed as a subterfuge for a bank's avoiding the regulation but that is plainly not the situation here. Plaintiffs were clearly more than nominal intermediaries between FNB and Arnold in light of their own prospective profit. Thus, it cannot be fairly argued that the loan by FNB to the plaintiffs was made for the purpose of purchasing stock within the meaning of Regulation U, even though the funds were ultimately used by Arnold to purchase stock.

As a second claim for relief, plaintiffs allege a pendent claim against FNB based on allegations of common law fraud consisting of alleged misrepresentations of an officer of FNB to the effect that he had reviewed the transaction and that it was regular in all respects. Since there is no federal basis for this suit, there being no Regulation U claim, there is no basis for pendent jurisdiction and the

second claim must therefore be dismissed. Leave to amend to assert this claim under Rule 10b-5 of the Rules and Regulations promulgated pursuant to Section 10b of the Securities and Exchange Act of 1934, as amended, will be denied as unavailing to plaintiffs who were not purchasers within the requirement of the *Birnbaum* doctrine, *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), as adopted in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (June 9, 1975), —— U.S. —— (1975).

The mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not of itself bring a transaction within the scope of the federal securities laws. *See, e.g., McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), *cert. denied* 43 U.S.L.W. 3449 (1975); *Rosen* v. *Dick*, [1974-75] CCH Fed. Sec. L. Rep. ¶ 94,786 (S.D.N.Y. Sept. 3, 1974). Thus, even if the FNB loan to Mallis and Kupferman were secured by a pledge of the Equity stock, which is disputed by EA and FDIC, plaintiffs could still not state a claim entitling relief under Rule 10b-5 on that basis since no purchase or sale was involved.

Similarly, there was no purchase by plaintiffs in this case. Plaintiffs loaned the funds to Arnold and Fowler, who had already contracted to buy the stock in question. While the stock later came into plaintiffs' possession as collateral for their loan, the consideration for that loan was the obligation by Arnold and Fowler to repay with a bonus. Attempts to characterize the transaction as a purchase of the stock by plaintiffs are not convincing. To allow persons in plaintiffs' situation to sue under Rule 10b-5 would be to expand the class of prospective litigants under that rule to an extent uncalled for by the words of the rule or the statute. *Cf. Bolger* v. *Laventhol, Krekstein, Horwath & Horwath*, 381 F. Supp. 260, 267 (S.D.N.Y. 1974).

Decision of the District Court.

The third claim seeks relief only against Bankers Trust Company for orally asserting that the stock certificates were no longer subject to the restrictive legend thereon tieing them to an escrow agreement while allegedly having knowledge that the certificates were void.

While this third claim is predicated on fraud under the Securities Act of 1933, as amended, no federal claim is asserted on which relief may be granted since plaintiffs were not "purchasers" of the securities. For the same reason, plaintiffs' offer to amend their complaint to assert a claim under § 10 of the Securities Exchange Act based on this allegation would be unavailing; permission to so amend is denied.

With respect to their offer to amend this third claim, plaintiffs claim that strict adherence to the *Birnbaum* purchaser-seller requirement for 10b-5 suits is no longer mandated in light of the holding in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). This claim is unpersuasive in light of the fact that the plaintiff in *Bankers Life* (the liquidator of Manhattan Casualty Co.) was clearly within the scope of the *Birnbaum* rule. *See Haberman* v. *Murchison*, 468 F.2d 1305, 1311 n.5 (2d Cir. 1972).

In *Bankers Life* the Supreme Court recognized that creditors of a corporation in the process of being liquidated have an interest in a suit brought by the liquidator, but the Court carefully added that

> . . . the fact that creditors of the defrauded corporate buyer or seller may be the ultimate victim does not warrant disregard of the corporate entity . . . The crux of the present case is that *Manhattan* [the corporate seller] suffered an injury as a result of deceptive practices touching *its* sale of securities as an investor. *Bankers Life, supra*, at 12-13 (emphasis added)

Decision of the District Court.

Opinions in the Second Circuit since *Bankers Life* have reaffirmed the vitality of the *Birnbaum* purchaser-seller doctrine except in a few narrow and irrelevant categories of cases. *Haberman, supra; International Controls Corp.* v. *Vesco,* 490 F.2d 1334, 1343, 1346 n.16 (2d Cir. 1974); *Petersen* v. *Federated Development Co.,* 387 F. Supp. 355, 358 (S.D.N.Y. 1974); *Gurvitz* v. *Bregman,* 379 F. Supp. 1283, 1286 (S.D.N.Y. 1974); *Davidge* v. *White,* 377 F. Supp. 1084, 1087 (S.D.N.Y. 1974); *Goodall* v. *Columbia Ventures, Inc.,* 374 F. Supp. 1324, 1329 (S.D.N.Y. 1974).

Leave to join Arnold and Fowler as involuntary parties pursuant to Rule 19 of the Federal Rules of Civil Procedure is also denied.

Rule 19(a) provides that

> [a] Persons to be Joined if Feasible. A person who is subject to service of process and whose joinder will not deprive the court of jurisdiction over the subject matter of the action shall be joined as a party in the action if (1) in his absence complete relief cannot be accorded among those already parties, or (2) he claims an interest relating to the subject of the action and is so situated that the disposition of the action in his absence may (i) as a practical matter impair or impede his ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest. . . .

None of the requirements of this Rule are satisfied by plaintiffs' request. In the absence of Arnold and Fowler "complete relief" can be "accorded among those already parties." Dismissal of this action would in no way "impair or impede" the ability of Arnold and Fowler to "protect their interests," nor would it "leave any of the persons already parties subject to a substantial risk of in-

curring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest."

The general rule is that if the merits may be determined without prejudice to the absent party, the Court "will strain hard to reach that result." *Bourdieu* v. *Pacific Oil Co.*, 299 U.S. 65, 70 (1936); *Charron* v. *Meaux*, 60 F.R.D. 619, 622 (S.D.N.Y. 1973).

FDIC has joined in the motion to dismiss submitted by EA and FDIC and EA have submitted a joint brief setting forth their discussion on the viability of the complaint. The positons of those two defendants are identical on these issues. The motion is granted. The first claim is dismissed for failure to state a federal claim upon which relief can be granted. The second claim is a common law claim pendent for jurisdiction on the first claim and is consequently dismissed for lack of subject matter jurisdiction over it.

Bankers Trust submitted two affidavits to the Court urging dismissal of the third claim in the complaint which is asserted against it alone. The plaintiffs have presented their legal arguments on this point and have responded to the Bankers Trust affidavits. That motion is granted. The third claim for relief, the only one directed towards Bankers Trust, is dismissed for failure to state a claim upon which relief can be granted and for lack of jurisdiction over the subject matter of the controversy attempted to be raised therein.

It appears that FNB is an insolvent, whose interests in this case have passed to FDIC and/or EA, and it thus seems appropriate to terminate this litigation in this Court by dismissing the claims as to FNB as well.

Complaint dismissed in its entirety.

So Ordered.

September 30, 1975

Milton Pollack
U.S. District Judge

Addendum to Memorandum Opinion of Pollack, D.J., Dated October 2, 1975.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

75 CIV. 909 (MP)

MEMORANDUM

SAMUE MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and THE BANKERS TRUST COMPANY,

Defendants.

APPEARANCES:

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Addendum to Memorandum Opinion of Pollack, D.J., Dated October 2, 1975.

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MILTON POLLACK, District Judge

Since the filing of the decision in this case, defendant Federal Deposit Insurance Corporation has called the Court's attention to 12 U.S.C. § 1819 (1970), which authorizes suit against this defendant in the federal courts on a state law claim.

Accordingly, the dismissal of Count 2 against this defendant is set aside and liability or any other matter pertaining to that claim alone may be reargued. Counsel should submit briefs accordingly within 10 days hereof.

SO ORDERED.

October 2, 1975

MILTON POLLACK
U.S. District Judge

Decision—Opinion of New York Supreme Court.

OPINION OF NADEL, J.

SUPREME COURT : NEW YORK COUNTY
INDIVIDUAL CALENDAR PART 8

Index No. 25831/72

SAMUEL MALLIS,

Plaintiff,

—against—

JEROME B. KATES, JUDITH KATES, JACK J. ARNOLD, JOHN B. FOWLER, JR., EQUITY NATIONAL INDUSTRIES INC., EQUITY-TAKE TWO, INC., THE NATIONAL BANK OF GEORGIA, BANKERS TRUST COMPANY and WILLIAM LONDON,

Defendants.

NADEL, J.:

The three separate motions for dismissal of the complaint brought at various times by defendants, Equity National Industries, Bankers Trust Company and William London are consolidated for the purpose of this disposition.

Plaintiff, a dentist, entered into an arrangement with his own lawyer, defendant Arnold, whereby he advanced the sum of $156,728 for one month, and was to receive a "profit" of $50,000.00. As collateral for this loan, plaintiff was to hold 40,384 shares of Equity National Industries, Inc. There is absolutely nothing in the letter from defendant Arnold and defendant Fowler, whose status in this transaction is otherwise undefined, to indicate from whom the Equity shares would be obtained. Plaintiff received $50,000.00. He did not even attend the closing where his funds were transmitted by an officer of Franklin National Bank.

The Equity shares were restricted. The two stock certificates bore a legend to that effect on their face, and on the reverse side spelled out an Escrow Agreement held by the National Bank of Georgia. Arnold asked for and received an affidavit from defendant Kates to the effect that the restrictive legend had no force and effect. The shares were held by defendant Bankers Trust Company as collateral for a loan it had made to defendant Kates. The closing took place at Bankers Trust. Plaintiff thereafter found the stock to be without value and brought this action in conspiracy and fraud against all parties having any connection whatever with the shares or the transaction.

Defendant London, who was Kates' counsel, drafted an agreement between Kates and Arnold, and had no knowledge as to the existence of plaintiff. Moreover, he did not attend the closing. Plaintiff alleges he was guilty of silence when he had a duty to speak, which amounted to a "fraudulent concealment" because he knew of the Escrow Agreement and did not inform plaintiff.

Bankers Trust is likewise charged with the same duty to speak for the protection of plaintiff Equity National Industries, Inc., and is charged with both fraud and negligence in permitting "escrowed stock" into the possession of defendant Kates, thereby allegedly aiding and abetting in the swindle.

Plaintiff is proceeding under several fallacies with respect to facts. The Escrow Agreement sets up two classes of shares, conditional shares which were issued to the stockholders of the company being acquired subject to recall if certain profits were not realized, and final shares, which were held by the escrow agent until the number of final shares to be exchanged for conditional shares could be determined. The conditional shares had a restrictive legend placed on both face and back of each certificate. The restriction did not per se make the stock "worthless"

as plaintiff contends. Equity National did not allow "escrowed shares" to circulate. These were final shares under the terms of the Escrow Agreement, which plaintiff could have determined from the National Bank of Georgia, the escrow agent, as well as transfer agent, if he had taken the precaution of examining the stock certificates.

The leading case on where there is a duty to speak is *Amend* v. *Hurley*, 293 N.Y. 587, which holds that barring a fiduciary or confidential relationship there is no duty to speak. Plaintiff had absolutely *no* relationship with defendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter arrangement with Arnold. No matter what he chooses to call his participation in this "investment", the Equity shares are called "collateral" and he is guaranteed *repayment* out of another stock transaction.

The "fraudulent concealment" he alleges against these defendants must fall on the basis of plaintiff's own exhibits in opposition to these motions. The legend showing a restriction on the sale or hypothecation of the shares appears on the face and back of both stock certificates. The court is unable to determine when or how plaintiff could or should have been informed by these defendants, who could not and did not know of his existence prior to the closing which he did not attend.

The motions to dismiss by these three defendants are granted. Settle orders.

s/ J. NADEL
J.S.C.

Dated: July 13, 1972